THE MILKEN INSTITUTE

Review

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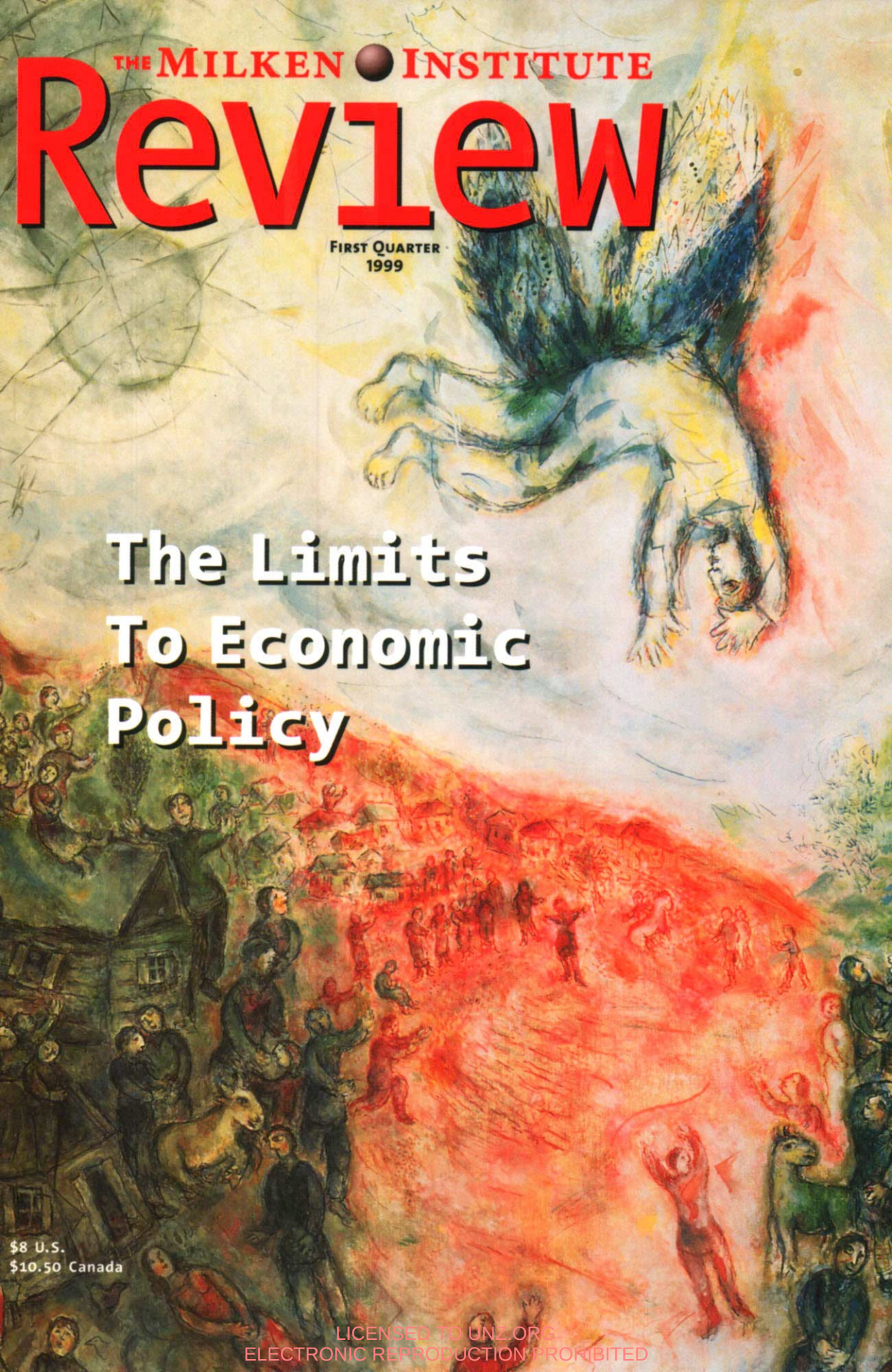

The Limits To Economic Policy

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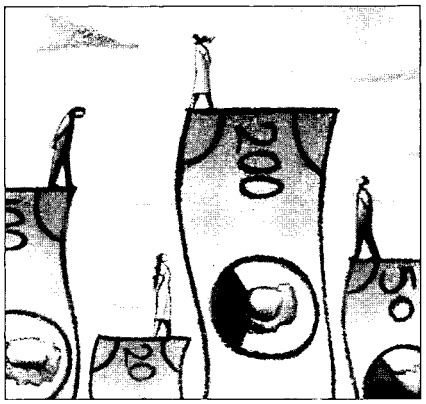

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EDITOR'S NOTE

Welcome to the inaugural issue of *The Milken Institute Review*, successor to the Milken Institute's quarterly magazine, *Jobs and Capital.* Our goal is to stimulate informed debate on economic policy, a subject too important to be left to the experts. Our writers have strong, unconventional views: why else print them?

But MIR itself will carry no ideological baggage. If you read a message between the lines – well, anything more than a deep respect for the moral and practical virtues of democratic capitalism – I'm not doing my job right.

The theme of this first issue (we didn't plan to have a theme; it just wafted in with the Santa Monica sunshine) is "over-reaching."

Paul Krugman of M.I.T. wonders why economists are absolutely, positively sure that the Great Depression can't happen again. "The eerie resemblance of many of today's problems to those our grandfathers faced," he says, "send chills up my spine."

Larry Lindsey, the former Federal Reserve governor, accuses euro-enthusiasts of hubris in their rush to a common currency. "The economic ramifications of a single currency zone are far-reaching," he points out, "and Europe may pay dearly for its failure to factor them into the political equation."

Dan Bachman of WEFA Inc. explores the irony that expectations of damage from Y2K could prove self-fulfilling. "Modest attempts by businesses and households to protect themselves against the bug could have a large economic impact," he predicts,

Barry Eichengreen of U.C. Berkeley takes a hard look at the conventional wisdom that international capital can never be too cheap or too mobile. "Wide-open capital accounts should be the exception in emerging markets," he concludes – "not the rule."

Nick Eberstadt of the American Enterprise Institute examines the unforseen consequences of China's one-child policy. "In laboring to avoid one set of population problems," he writes, "Beijing has insured that another, arguably more daunting, set will emerge in the decades ahead."

We've also included an excerpt from **Bob Frank**'s new book, *Luxury Fever*, an attack on the shop-till-you-drop syndrome from a card-carrying member of the economics establishment. And for a little relief from all this Sturm und Drang, we've got a cool-looking charticle, a self-graded quiz, as well as a cartoon strip from **Mark Alan Stamaty**, the creator of *The Washingtoon.*

What's unavoidably missing from this first issue is feedback from you, dear readers. We are eager to print your comments, rebuttals and the like. Indeed, we will be inconsolable if you fail to write the editor (or e-mail at ppassell@milken-inst.org) to gently correct our contributors' misunderstandings of how the world works.

–Peter Passell

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The kindness in my father's eyes took nothing away from his serious message. "Never forget," he said sternly, "Businesses are built on trust, and trust starts with the balance sheet."

BY MICHAEL MILKEN

I was only 8 years old and, at first, didn't really understand what a balance sheet was. But I'd shown a knack for numbers and my father, a lawyer and C.P.A., encouraged this gift by teaching me how he analyzed different businesses. Soon, I was able to tote up the items in financial statements and, within a few years, began to appreciate their mathematical symmetry.

Later, while studying business at Berkeley, I investigated credit and discovered what looked like a paradox. Sovereign debt – the obligation of nations – was widely thought to have the least chance of default. In fact, it was more volatile and carried a greater risk than the debt of companies or even individuals.

Investors in government securities around the world had fared worse throughout history than those who had purchased the debt of businesses. And as the last three decades have shown, high-yield, non-investment-grade corporate debt (a.k.a., "junk") has provided a significantly better total return than the obligations of blue-chip companies. Generous yield spreads more than offset greater credit risk.

What was going on here? Why weren't balance sheets accurately measuring risk? This question led me to new theories of credit. It was clear that the true value of a business (or, for that matter, of a household or a country) is often not fully reflected in the audited numbers because markets value assets that don't show up on the balance sheet.

LOOKING IN THE REAR-VIEW MIRROR

During my graduate studies at Wharton, I worked as a consultant at a leading investment banking firm and further developed my ideas on risk and access to capital. When I went to Wall Street in 1970, I found that those who controlled or influenced the allocation of capital were still making financing decisions based on the past rather than the future. A hundred-year-old sewing machine company was considered investment grade and could borrow money at favorable rates. But many forward-looking enterprises filled with talented management, bold ideas, valuable patents and the latest technology were too "speculative" to deserve financing. Capital was provided to a very narrow range of companies.

In those days, I had a 5-hour round-trip bus commute, giving me time to study thousands of financial statements. It became clear that the traditional yardsticks appropriate for the Industrial Age needed updating for what we now call the Information Age.

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FROM THE CHAIRMAN

When equity investors saw businesses organizing themselves to take advantage of changing tastes and consumer needs, they looked beyond annual statements and invested in those companies based on their business plans rather than their physical assets. The resulting increase in stock prices created real wealth; but traditional lenders discounted it and looked only to the "hard" assets on the balance sheet to cover their loans.

This shut out thousands of promising companies – including almost all minority-owned enterprises – from the capital to support their growth. They needed a new financial tool to replace traditional balance-sheet analysis and recognize what their assets could be worth in the future. This need gave birth to the concept of market adjusted debt ratios that recognizes value beyond the balance sheet. True to my father's credo, I wasn't rejecting balance sheets, but adapting them to reflect future potential. The financial technologies that evolved from this concept provided access to capital to thousands of worthy non-investment-grade companies, in the process creating millions of jobs.

To cite just one example, in the 1970's MCI was a small company with a few hundred employees. Traditional lenders, looking at its balance sheet, weren't interested in financing this upstart's quest to take on the industry colossus, AT&T. But with the help of innovative financial tools, MCI financed its growth and created some 60,000 jobs.

Similar growth through new forms of financing created hundreds of thousands of jobs at such companies as Time-Warner, TCI and many others. In fact, since 1970, while the "investment grade" companies of the Fortune 500 have downsized, eliminating some three million jobs, small and medium-sized companies have created more than 55 million new jobs in the United States. By contrast, in the same time period, Europe has not created a single net new job in the private sector, largely because smaller European companies haven't had comparable access to capital and financial technology.

HUMAN CAPITAL

What is the key asset not shown on the balance sheet? It sounds too simple, but a good part of it is people. In today's knowledge-based economy, nothing equals the contribution of people.

Consider this: After the announcement several years ago that Motorola's chairman, George Fisher, would become chairman of Eastman Kodak, Kodak's stock shot up $1.6 billion while Motorola's fell $300 million. Nothing changed on the balance sheet, but within hours the market saw a change of nearly $2 billion in value.

The value of "human capital" is nowhere more obvious than in the business of sports. When a Michael Jordan joins the Chicago Bulls, the team win more games, attendance shoots up and team owners are able to raise ticket prices substantially.

Although not a new phenomenon, the importance of human capital is growing as we continue the evolution from an industrial society to a knowledge society. Early in this century, 60 percent of the cost of producing an automobile was in raw materials and energy. For today's computer chips, it's 2 percent of the cost. The key ingredient isn't silicon, but intellectual and human capital.

UPDATING M.A.D.

Today, as the accompanying chart shows, market-to-book values are at an all-time high. What are we to make of this? Some

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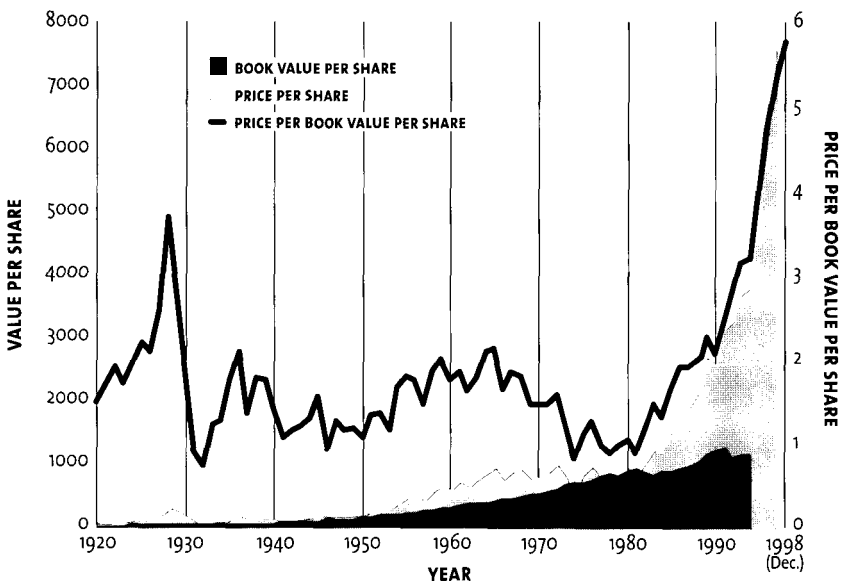
would say that the market is simply irrational. Perhaps it is. Another interpretation is that the book value shown on balance sheets doesn't reflect intangible assets such as human capital, management information systems, software and digital distribution systems that are increasingly important in a knowledge-based economy.

As this year began, the market valued Microsoft at approximately $350 billion, more than 17 times its book value and more than $12 million for each Microsoft employee. Clearly, the market has made the decision that Microsoft's human capital and other intangibles far exceed the hard assets on the company's balance sheet. In fact, investors are so optimistic about the future income of Microsoft, a company founded less than 25 years ago, that they have given it a market capitalization about equal to the gross domestic product of Russia.

MARKET-TO-BOOK RATIO

(Stocks in the Dow-Jones Industrial Average)



Over the past 30 years, most job creation in the United States has occurred in companies that didn't exist or weren't considered investment grade 30 years ago. Market adjusted debt ratios proved to be a better way of predicting this than traditional balance-sheet analysis. But what is the right tool for measuring value and risk in the next three decades? I believe the answer will be found by those who develop the best understanding of what defines income-producing assets in a digital world. One thing seems obvious: those assets are not fully reflected on the balance sheets of modern businesses.

The Nobel Memorial Prize-winning economist Gary Becker has estimated that traditional balance sheet assets represent only 30 percent of the wealth of America; 70 percent of the wealth is in human capital. This human capital, combined with access to financial capital, technology, open markets and the rule of law, are the "raw materials" for a powerful economy. Traditional balance-sheet assets – real estate, office buildings and factories, coal, oil, steel mills – have become less important.

With so much of the capital in the world off the balance sheet, we would do well to modernize financial reporting and build for the future by strengthening our education and training infrastructure. M

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In popular legend,

the Great Depression was the second act of a morality play – punishment for sins of the past, a hangover from the excesses of the Roaring Twenties. Sensible economists, however, have never subscribed to that view. On the contrary, they regard the Depression as an unnecessary tragedy: what might have been a more or less ordinary recession, soon forgotten, became a nightmarish slump thanks to the stupidity (or at least ignorance) of policy makers.

BY PAUL KRUGMAN

If only the Federal Reserve had not been preoccupied with defending the gold standard instead of the nuts and bolts economy. If only Herbert Hoover had not followed Secretary of the Treasury Andrew Mellon's advice to "liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate – purge the rottenness out of the system." Then, most of us believe, the catastrophe could easily have been avoided. Since we know better now, it can't happen again.

Or can it?

As recently as two years ago, like most of my colleagues, I was quite confident that while the age of economic crises was by no means past, 1930's-type crises, in which the world slumps simply because businesses and consumers spend too little, were obsolete. Economists and policy makers had learned the lessons of that decade and would never again perversely tighten monetary and fiscal policy in the face of recession.

Now I'm not so sure.

For one thing, many countries have tightened credit and reduced spending in the face of recession – not because their leaders are stupid or ignorant, but because global capital markets leave them no choice.

Consider the plight of Brazil. The country has a problem: it is running a budget deficit that must be brought under control, though a cool look at the figures would suggest that the Government's solvency is not in any immediate danger. Still, markets have fixated on deficit reduction as a symbol of the Government's determination to act responsibly. So taxes must be raised and spending cut.

A tighter fiscal policy, however, will reduce overall economic demand. So, will the Government compensate by cutting interest rates in order to avoid a recession? Certainly not. To cut interest rates would be to risk capital flight, which would undermine the value of the currency.

Indeed, to defend the Brazilian real the cen-

PAUL KRUGMAN is a professor of economics at the Massachusetts Institute of Technology. His most recent book, *The Accidental Theorist*, was published by W.W. Norton.

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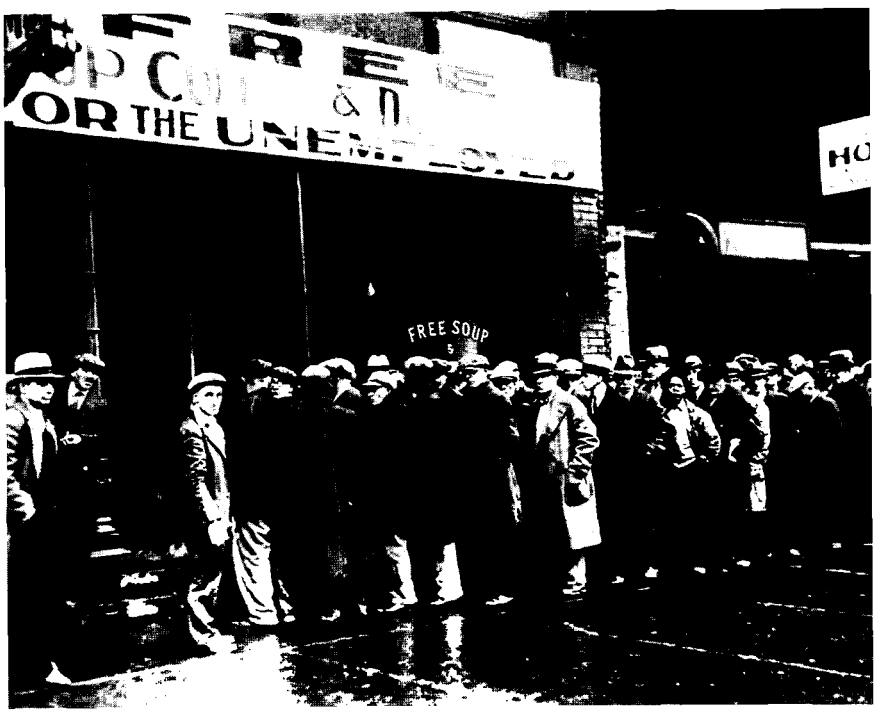
tral bank has twice actually raised interest rates sharply – once last fall in an attempt to prevent a devaluation and again in January to keep the devaluation that took place anyway from triggering even greater capital flight. In short, fear of speculators has forced Brazil (and many other smaller economies) not only to live with the risk of recession but to follow policies that will deepen the prospective slump.

Larger, richer economies are not so helpless. The United States, the European Union and Japan are big enough to brush off the sort of speculative attacks that terrorize less fortunate nations. Yet even these powerhouses have lately been experiencing a bit of Depression economics.

Take Japan. Over the past two years the Japanese economy – which was already operating well below capacity – has gone into a tailspin. So why don't the Japanese get their economy moving with monetary and fiscal stimuli? The answer is that they are doing everything they can within the conventional limits of sound policy, and it still isn't enough.



CORBIS

Chicago 1933

Interest rates are near zero (some deposit rates are actually negative), and the Government is running a budget deficit likely to top 10 percent of national income next year. That's as if the United States Government were to run an $800 billion deficit, a fiscal stance worse by any measure than Brazil's. And still Japan's economy is heading south, with the usual forces of recession now compounded by accelerating deflation.

What's going on? Some will tell you that it's all due to problems specific to Japan: bad banks, over-regulation, inefficient corporations. I don't buy it. As recently as five years ago many of the things now smugly condemned as weaknesses (like the close relationships between banks and their customers) were hailed as the secrets of Japan Inc.'s success – and often by the same people.

No. What's happening is something more generic: Japan now finds itself in a classic "liquidity trap." Consumers are so worried about the future that they try to save a high proportion of their income. Businesses, also worried, are unwilling to invest all those savings, even at a zero interest rate. While the Japanese

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Government can try to fill the hole with its own deficit spending – in effect, offsetting the private sector's excess saving with public dissaving – gigantic deficits lead to questions of the Government's own solvency. Indeed, Moody's has just downgraded Japanese Government bonds.

Don't get me wrong. The world is probably not headed for another Great Depression. The big developed economies are not going to experience crises such as those in Brazil or Indonesia; nor are there signs of Japanese-style problems emerging in North America and Europe. But, I wish I were as confident as I used to be. The eerie resemblance of many of today's problems to those our grandfathers faced – the way Indonesia in 1998 is reminiscent of Austria in 1931; the similarities between contemporary Japan and the United States in the 1930's – sends chills up my spine.

Indonesia: 1998

CHRISTOPHER MORRIS/BLACK STAR

What does it mean that we have managed to reprise the great slump, if only in a minor key? One lesson is that economists were far too self-congratulatory. It is true that we understand economic cycles much better than people did in the 1930's, but we do not understand them as well as we thought we did. Anyway, knowledge is not always power: the Brazilians understand the risks of their economic policy, but don't see a better option.

The other lesson may be even more disturbing. In the aftermath of the Depression, almost all of the world's governments rejected traditional economic virtues. In place of free markets, they introduced heavy regulation; in place of sound money, they resorted to inflationary expansion.

With time, however, economists and politicians once again began to appreciate the ancient virtues, and once again the world became a place of more or less free markets and more or less stable prices. Sure enough, along with the rediscovery of old-fashioned rectitude has come the rediscovery of old-fashioned crises. Free markets, we find, are too often unstable, while a world without inflation all too easily becomes a world of uncontrollable deflation.

This doesn't mean we should turn the clock back to, say, 1970. The evils of excess regulation and the costs of inflation were not figments of our imagination. Neither were the risks to which those bad old policies were themselves a response. What the world needs now is a way to regain stability without condemning economies to inefficiency. I'm open to suggestions.

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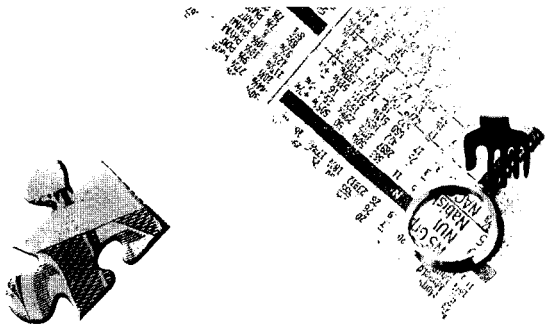

So you think you know a lot about financial markets? Test yourself in the privacy of your own living room. Those who score 100 percent are hereby declared honorary masters of the universe.

–Thanks to Bob Sobel and Glenn Yago.

1. Which of the following raised capital for the first time by issuing below-investment-grade securities?

a. U.S. Steel **b.** Goodyear
c. General Motors **d.** I.B.M.
e. United States Government

2. Which category of borrowers has the highest historical default rate?

a. consumers **b.** corporations
c. sovereign nations

3. In what year did the market capitalization of Microsoft first exceed that of General Motors?

a. 1986, the year Microsoft went public.
b. 1989 **c.** 1995 **d.** never

4. In 1980, AT&T had a AAA bond rating. The debt of its young rival MCI was rated CCC. Which company has proved a more reliable source of employment?

5. Investors in which bear market took the biggest bath?

a. stocks in Oct. 1987 **b.** stocks in Sept. 1998
c. high yield bonds in Feb. 1990
d. Treasury bonds in Nov. 1982

6. Bond ratings were introduced:

a. during the Depression as a government measure to restore investor confidence.
b. when money-center banks needed a method of classifying secondary market securities in their portfolios.
c. before World War I, as a private market response to a series of financial panics.

7. True or false. Hostile takeovers are a phenomenon of the 1980's.

8. Seed money and start-up financing for new enterprises soaks up what percentage of total venture capital?

a. 5 percent **b.** 20 percent
c. 50 percent **d.** 80 percent

9. Speaking of venture capital, which two states absorb half of all new venture capital?

a. New York and Washington
b. California and Texas
c. Massachusetts and California
d. Arizona and Texas

10. Women own what percentage of American businesses?

a. 5 percent **b.** 15 percent
c. 30 percent **d.** 50 percent

11. In 1982, 60 percent of the Forbes 400 had inherited the bulk of their wealth. What was the comparable figure in 1997?

a. 20 percent **b.** 50 percent
c. 80 percent **d.** 90 percent *answers on page 81*

BRYAN LEISTER

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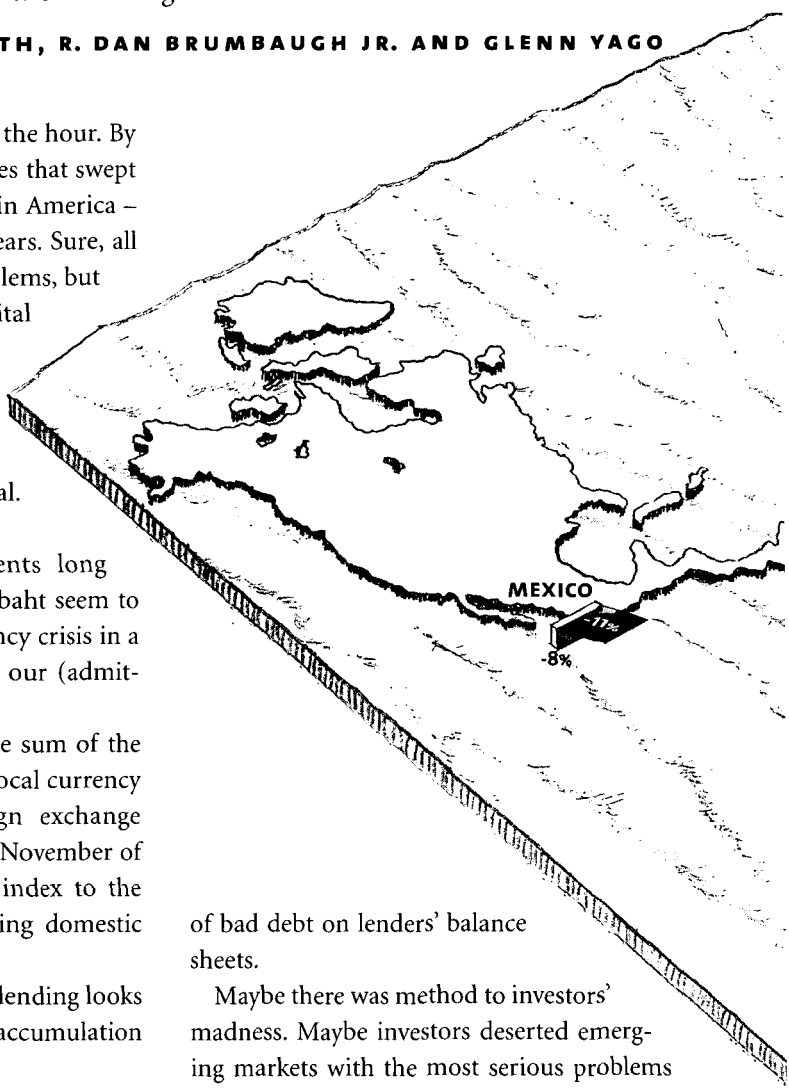
CHARTICLE

First Thailand. Then Malaysia, Indonesia, Korea, the Philippines and Brazil. Next Venezuela? Argentina? China? Poland?

BY JAMES R. BARTH, R. DAN BRUMBAUGH JR. AND GLENN YAGO



"Contagion" is the bogeyman of the hour. By most accounts, the currency crises that swept through Asia – and threaten Latin America – were the product of irrational fears. Sure, all the affected economies had problems, but the immediate cause of the capital flight was panic as investors followed the herd into dollars and yen and D-marks. No emerging economy will be safe until the herd is back in the corral.

Or so the story goes.

There's just one catch: events long before the collapse of the Thai baht seem to predict the severity of the currency crisis in a variety of countries. Check out our (admittedly crude) Crisis Index.

The index is calculated as the sum of the percentage depreciation of the local currency plus the percentage of foreign exchange reserves lost from May through November of 1997. Now compare the crisis index to the percentage change in outstanding domestic credit from 1992 through 1996.

The growth of (mostly bank) lending looks like a pretty good proxy for the accumulation of bad debt on lenders' balance sheets.

Maybe there was method to investors' madness. Maybe investors deserted emerging markets with the most serious problems and stayed the course in markets that had kept a lid on crony capitalism such as Hong Kong and India.

JAMES BARTH and DAN BRUMBAUGH are Senior Finance Fellows at the Milken Institute. GLENN YAGO is Director of Capital Studies at the Milken Institute.

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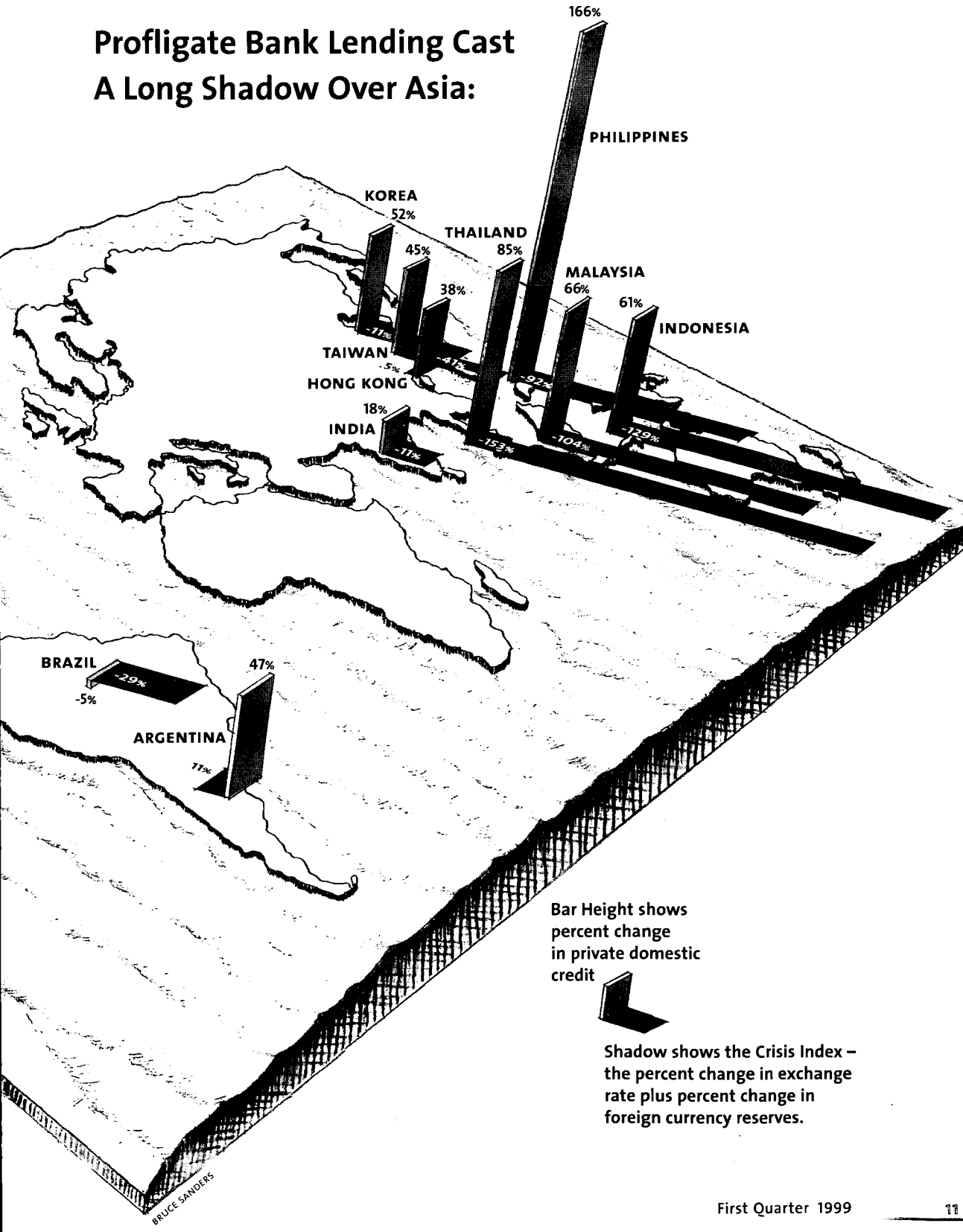
Profligate Bank Lending Cast A Long Shadow Over Asia:



Bar Height shows percent change in private domestic credit

Shadow shows the Crisis Index – the percent change in exchange rate plus percent change in foreign currency reserves.

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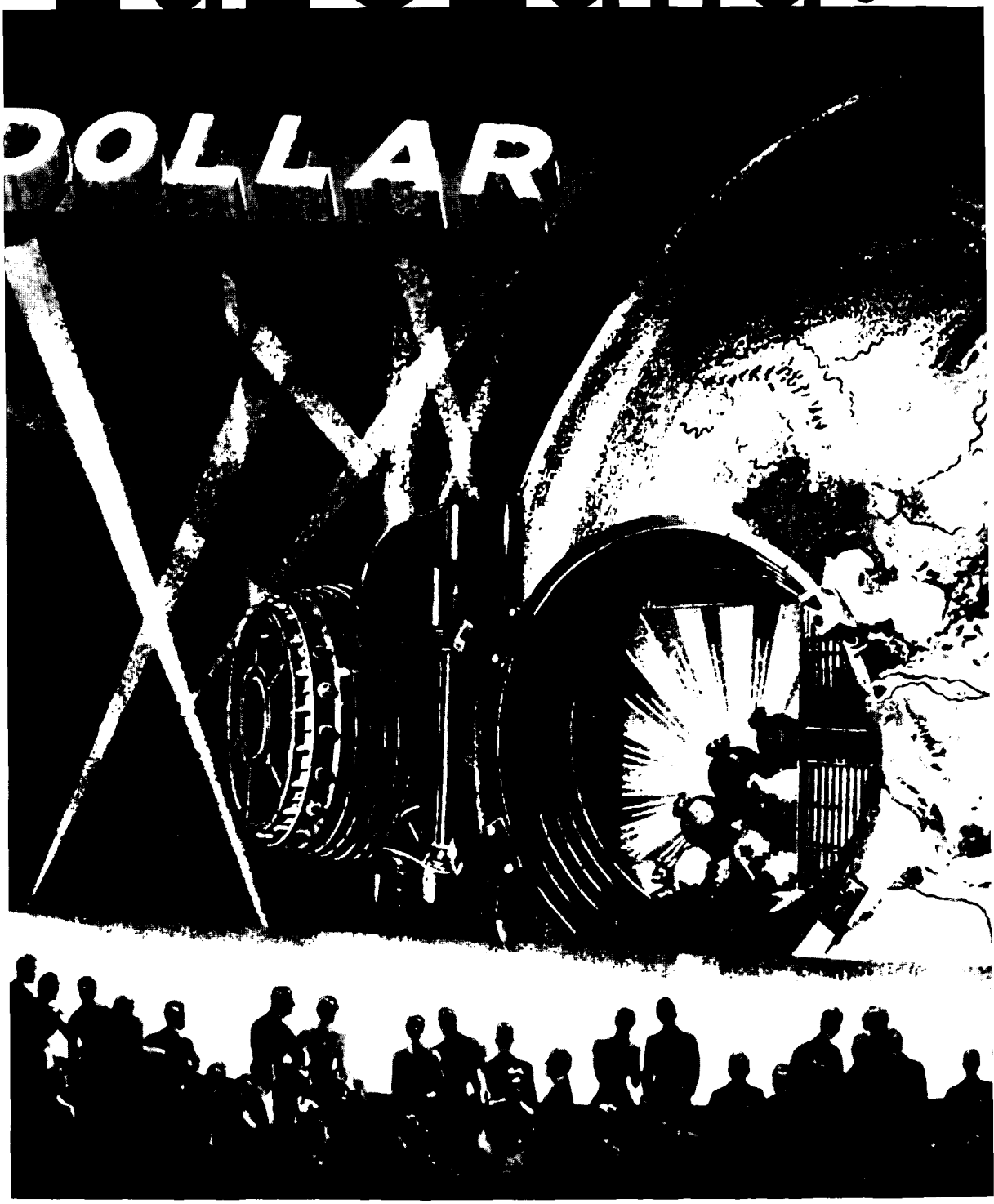
Euroland:



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The Morning After

The vision is political - one continent, one peaceful people. But monetary union could also mean big economic trouble for Europe and the world.

For many European politicians, monetary union is the next step in the dream of a United States of Europe. What few Americans – or Europeans – realize is that the European Monetary Union could profoundly affect one of the most successful international alliances in history. And, in this case, ignorance is not bliss.

Since the advent of the cold war, Washington has been inclined to support the vision of European federalists. A united Europe, it was widely argued, was likely to be a more effective bulwark against Soviet expansion – as well as one that could pay for its own defense. With victory in the cold war, this rationale for supporting European federalism disappeared. Yet the Clinton Administration, preoccupied with domestic issues, never paused to re-examine the issue.

It is now beginning to sink in that a united Europe could threaten American interests. Indeed some European federalists, jealous of the role of the dollar in world trade, hope that this is so.

Charles de Gaulle used to fret that America was the only country in the world that did not have to worry about running a chronic trade deficit because the rest of the world would absorb the surfeit of dollars as official government reserves. And such sentiments live on: In the fall of 1997, Europeans floated the rumor that the People's Bank of China would substitute the newly created euro for a substantial portion of its reserves. Though Beijing denied the rumor, it hasn't scotched visions of creating a potent competitor for the dollar.

By Lawrence B. Lindsey

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EUROLAND

From the perspective of the United States, the introduction of a rival currency should not be all that worrying. True, a successful global currency is a profitable asset since the outstanding currency amounts to an interest-free loan to the issuing government. Foreign holdings of dollars approach roughly $300 billion, saving Uncle Sam roughly $15 billion in interest payments.

The United States probably saves an equal amount because dollar-denominated assets are so readily accepted as a way to store wealth, reducing the interest cost of borrowing in dollars. All told, the dividend to America's financial hegemony is probably worth some $30 billion annually.

But even European chauvinists do not expect the euro to replace the dollar entirely as the reserve currency. And in any event, the competition should generate some ancillary benefits for the American economy.

Start with the reality that a strong Euro would make the rest of the world less forgiving of an undisciplined monetary policy in America. This would make a rerun of the inflationary spiral of the late 1970's much less likely, since world financial markets would short-circuit any attempt to ease the pain of recession with a flood of dollars.

The real worry is not the emergence of a competitor for the dollar, but consequences of monetary union on European policy and politics. For whatever impact the euro might have on the role of the dollar is sure to be dwarfed by its impact – direct and indirect – on trade, price stability and, ultimately, the health of the global economy.

LARRY LINDSEY, a former governor of the Federal Reserve Board, holds the Arthur Burns Chair at the American Enterprise Institute. He is the author of *Economic Puppetmasters: Lessons from the Halls of Power* (AEI Press).

A CURRENCY'S FACTS OF LIFE

"All currencies end badly," wrote René Sédillot, the French financial historian. They are born out of political hope, then die when changing political priorities make their existence untenable. And the current European national currencies are failing because they stand in the way of a key political objective: containing German influence.

The German industrial and financial engine has dominated Europe since the 1950's. As a result, the German mark has dominated Europe monetarily. France's monetary policy has not been made in Paris and Italy's has not been made in Rome because neither country can afford to go its own way on interest or exchange rates.

The Germans acquiesced, albeit reluctantly, to a change in this system as part of a broader deal negotiated by Helmut Kohl, who was chancellor at the time. Kohl's vision for Germany was shaped by his personal experiences during and after World War II. His twin goals for Germany were reintegration of east and west and then integration of a united Germany into Europe. Like most European federalists, he favored a united Europe as the way to prevent continental wars and, in particular, to avoid a repeat of the disasters of the 20th century.

In return for Germany's giving up the mark, the rest of Europe accommodated it by agreeing to be governed by a European Central Bank on the German model. At least on paper, this bank will be as independent of political pressures as any in history and will have price stability as its objective.

But the economic ramifications of a single currency zone are far-reaching, and Europe

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may pay dearly for its failure to factor them into the political equation. To understand why, step back a bit. In an economy the size of Europe there are bound to be significant regional differences in performance. And in a world of multiple currencies, exchange rates usually serve as buffers, increasing the competitiveness of depressed regions by allowing their currencies to depreciate. Thus, for a single currency to be successful, politicians must find other ways to ameliorate regional differences.

As a practical matter, there are two principal alternatives: moving workers and reducing income inequality with fiscal transfers. Roughly one American in six changes residence each year, and seven million to eight million move to another state, typically to take new jobs. During the California recession in the early 1990's, 1.2 million people left the state, with many going to the rapidly growing Rocky Mountain region. Utah's labor force grew by 24 percent in just four years.

Europeans do cross borders in search of work, but the patterns are quite different. While there are ongoing flows from poorer regions to richer ones, individuals rarely leave one rich part of Europe for another rich part in response to the changing labor markets.

America's national tax system also serves as an automatic income stabilizer. During the business cycle of late 1980's and early 1990's, California's marginal contributions to federal receipts fell from 17 percent in the boom to just 8 percent during the bust. This difference generated a net fiscal injection of roughly $11 billion in 1994 alone, or more than $350 per resident. The impact on Massachusetts was even greater; it had a swing of $550 in per capita tax payments from peak to trough.

Europe has neither a potent automatic stabilizer like the United States income tax nor a

tradition of demand-driven migration. Taxes are still national. And although mandatory national contributions to the European Union are somewhat sensitive to economic activity, the fiscal buffer is far less effective than in the United States. Furthermore, linguistic and cultural differences present much greater impediments to migration. Thus, the forces cushioning regional recessions are far less effective.

The problems created by currency union are already apparent on the periphery of Europe. While an easy monetary policy is being used to ameliorate the recession in the

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French-German core of Europe, Ireland, Spain and Portugal are booming. Ireland and Portugal should be raising interest rates. Instead, they have had to lower them to converge with the rates prevailing in France and Germany. As a result, their real estate and financial bubbles will continue to inflate.

But regional tensions are not the only sort of problem the new European Monetary Union faces. There is a natural conflict between the legal mandate to pursue price stability and the desire of politicians to spur growth in a continent-wide economy that has suffered from record unemployment for the better part of a decade. Unfortunately, the new arrangements in Europe will not provide an easy way out.

On first glance, the structure of the new European Central Bank resembles that of the Federal Reserve's Federal Open Market Committee. The members of the E.C.B. and the F.O.M.C. reflect roughly the same balance of power between the center and the regions. Membership in the F.O.M.C. includes seven Federal Reserve Board governors, appointed by the President. In addition, the 12 regional bank presidents take turns as voting members. In the E.C.B. there will be six officers at the center joined by the heads of the 11 national central banks whose governments are part of the European Monetary Union.

But consider how the members are picked. In the United States, the presidents of the regional banks are jointly selected by the regional board of directors and by the board of governors in Washington. What's more, three of the nine members of each regional board – including the regional board's chairman, deputy chairman and a majority of the "search" committee for the regional President – are selected by Washington. It is only a slight exaggeration to say that the Federal board of governors selects the regional bank presidents.

It is also important to stress that in the United States, state and local political authorities have no formal say over the selection of these regional bank presidents. And since each of the 12 Federal Reserve regions include portions of several states, it is hard to organize political coalitions to influence the selection process in less formal ways. This system produces policymakers who tend to be above the political fray and interested in national – as opposed to regional – economic issues.

By contrast, the European Central Bank is built up from the regions. The national banks of the members will each send their heads to Frankfurt to sit on the E.C.B. governing council. These individuals will, in turn, have great say over the selection of the central bank officers. The center-based candidates are therefore responsible to the regions, while at the U. S. Federal Reserve the regional representatives are responsible to the center.

In addition, European member governments select the regional representatives. And though the central bankers are technically independent, it is only natural that they will reflect the views of the governments that select them. Thus while the Fed tends to act like a corporate board, the E.C.B. is designed to work more like a legislature.

A corporate board generally tries to find a single policy in the best interest of the whole. A legislature tends to arrive at a compromise reflecting the path of least political resistance. The difference between the two approaches is often hard to detect. But in a crisis, corporate directors are far more capable of acting decisively than legislators.

A second component of the governance problem is that the new European Central

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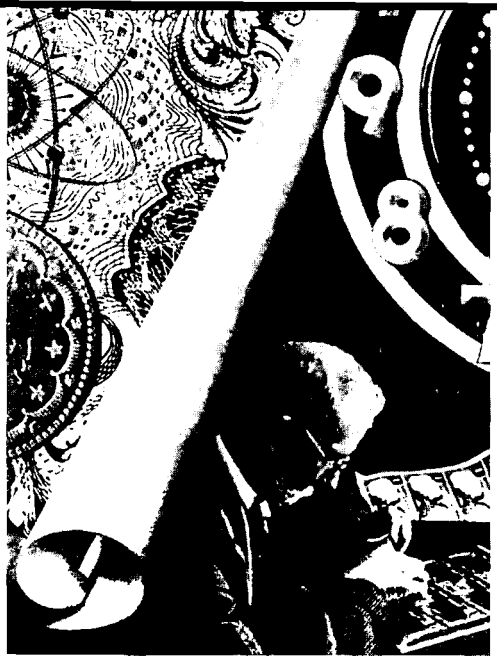

Bank lacks democratic legitimacy and accountability. Federal Reserve Board governors are appointed by the President and confirmed by the Senate. Their independence is derived from their long (14-year) tenure, which insulates them from electoral politics. Nonetheless, they remain indirectly accountable to the electorate that sustains and supports all political institutions.

Governors of the Federal Reserve are continually asked to testify before the Congress on a variety of subjects. Not only is their job tenure dependent upon the national legislature, the existence of the Federal Reserve can be changed by legislation at any time. By contrast, the European Central Bank is created by treaty among the member states and has no escape clause or process for amendment except by unanimous agreement of the signatories.

THE EFFECT ON POLITICS AND ECONOMICS IN EUROPE

What conclusions can we draw about the likely behavior of the new European Central Bank and its effect on the European economy in coming years? One is that it will be preoccupied with the mechanics of integration.

Establishing an entirely new currency is a daunting practical challenge. At first, domestic currencies will continue to circulate and the euro will be used only for large payments and as the unit of value in new government bonds. Then, during a short transition to begin in January 2002, the economies of Europe will switch to the new euro-denominated notes and coins. The technical details, particularly the establishment of a new euro settlement system, are likely to consume a major portion of decision makers' time.

This is not a hopeful development at a moment of global financial crisis. The distraction has already been reflected in Europe's failure to adapt to the changing global environment. In 1998 Europe failed to pull its own weight in the distressed world economy: Its imports from Asia grew more slowly than American imports from Asia. This not only harmed Asia, which was struggling to climb out of depression, it also stirred latent protectionism in the United States: President Clinton recently complained that America has become the importer of last resort.

Look, too, for rising tensions between the new central bank and the elected officials of national European governments. The central bankers will naturally want the euro to be viewed as a "hard" currency – a good store of value – rather than a "soft" currency apt to depreciate in crises. Failure to establish this at the inception would be catastrophic for the new currency because credibility, once lost, is virtually impossible to regain. But with Europe choosing left-leaning Social Democratic governments in the most recent elections, don't expect the national capitals to acquiesce with grace. Already the newly elected Red-Green government in Germany is at odds with the Bundesbank.

This fight will end in one of two ways. Either the E.C.B. will successfully maintain a

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"hard" euro policy, or the politicians will successfully undo Chancellor Kohl's deal for an independent central bank with an exclusive mission of price stability. I'm betting on the politicians, if only because the E.C.B. lacks the democratic legitimacy needed to make unpopular policies stick.

Heads we lose, tails we lose. If the bank prevails, the key stimulative tools now available to government will all but vanish: The Maastricht Treaty, which created the euro and committed the E.C.B. to stabilizing prices also placed limits on the capacity of member governments to run budget deficits. Deficits were to be limited to 3 percent of gross domestic product.

Since many European countries, mired in recession, are already up against the 3 percent limit, the fiscal option is officially off the table. Politicians are mulling a way of getting around the treaty's strictures: "Infrastructure investments" (such as roads, bridges and other forms of political pork) may be ruled outside of national budgets. But such a dodge would make the E.C.B.'s goal of establishing credibility a bit more difficult and is likely to be resisted.

The lack of palatable direct options for fighting recession leaves European politicians with an unpalatable indirect one: protectionism. A host of trade conflicts with the United States already loom, with subsidies to Airbus, Boeing's main global competitor, at the top of the list. Others are bound to occur in agriculture, financial services and intellectual property. The most likely consequence of a "hard" euro, therefore, is a more intransigent European position on trade.

Unfortunately, a victory for the politicians over the E.C.B. would not necessarily defuse trade tensions because other, more technical issues are likely to push Europe toward a "hard currency" stance. One of the key problems any monetary authority faces is determining the standard for judging the efficacy of monetary policy. The objective of the new European central bank is to maintain price stability. But there is no single "market basket" in Europe to serve as a benchmark for prices. Instead, the E.C.B. will have to deal with a variety of national price indices, each assembled under different methodologies.

The European bank might seek to stabilize a weighted average of all the market baskets. But just how does one stabilize prices in general when some member states are enjoying inflationary booms with full employment while others are in recession and suffering falling prices?

Remember, too, that financial markets will lack experience in interpreting the European Central Bank's policies. And almost inevitably, financial players will look to the one remaining yardstick of stability with which they are familiar: the exchange rate. So even if the bank does not formally target the exchange rate of the euro against other major world currencies, Europe will not be able to ignore it.

If, for example, the exchange rate were to slip to parity with the dollar, it is virtually certain that the markets would assume that European monetary policy was too loose. On the other hand, when the soon-to-be euro's effective exchange value went to $1.20 last year, the screams of pain from European exporters caused some central banks to intervene in favor of the dollar. Thus, it is likely that attention will be paid to maintaining the euro in the $1 to $1.20 range.

If the politicians prevail, one of the key effects of an easier monetary policy will be an exchange rate between the euro and the dollar

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near the 1:1 end of this band. European exports will become more competitive in the American market, while American exports will become less competitive in Europe. This would amount to disguised European protectionism, and the euro would, inadvertently, undermine the long Atlantic consensus in favor of free trade. The best we can hope for is that both America and Europe recognize that in a world of exchange rate instability, the world simply cannot afford competitive devaluations in the two largest economies.

The high-profile, brute-force nature of exchange rate manipulation makes it the most dangerous weapon one can use in a trade war. Garden-variety protectionism, by contrast, usually plays out in dozens of confusing, numbingly boring cases fought before domestic courts and the World Trade Organization. But the exchange rate can be the topic of headlines in the financial press – and if things get bad enough, in the popular press as well. Will we see *USA Today* headlining "Euro strikes new low blow against dollar"? Or will *Le Figaro* expound on the "La Dollar Menace"?

From this perspective, the current buzz about the euro replacing the dollar as a world reserve currency seems out of place. If the new euro is used as a weapon in a trade war, or even as a last-ditch means of exporting Europe out of recession, it will not be perceived as a reliable store of value. Indeed, if the euro is used as a recession fighter, the more likely challenge to the prevailing Atlantic relationship will come from a weak euro, not a strong one.

There is another reason to expect the euro to be weak. Under the current multi-currency regime, most of the effect of one European country's devaluation is felt by other European countries. In a devaluation of the Italian lira, for example, the major losers would be French farmers and German manufacturers. As such, using exchange rate policy as an economic tool has widely been viewed as anti-European.

But with a single European currency, this constraint will vanish. Devaluation becomes pro-European since the losers will be American and Asian exporters and the winners will be their European counterparts.

European policy makers have shown a proclivity to be much more producer-friendly – and less consumer-friendly – than their American counterparts.

Of course, European consumers have as much to lose from competitive devaluation as foreign producers. For better or worse, though, European policy makers have shown a proclivity to be much more producer-friendly – and less consumer-friendly – than their American counterparts.

Europe's multi-currency system is dying because it no longer serves Europe's governing elite. But the economic ramifications of the decision to switch to just one currency are global, not merely local. America is surely right in worrying about potential competition from the euro. But it is not the sort of competition that most Americans or Europeans expect. It will be a competition driven by weakness, not strength.

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The Millennium Bug

Self-Fulfilling Prophecies

By Daniel Bachman

The Year 2000 computer problem has by now received considerable attention from pundits and technology gurus. Technical details – how many computers might be affected, how many factories might shut down, whether major systems will survive the onslaught – remain fuzzy. Nonetheless, opposing camps have already emerged. The Chicken Littles, led by Ed Yardeni of Deutsche Bank, are convinced that the sky will fall. Meanwhile, the consensus of the Philadelphia Fed's venerable Survey of Professional Forecasters suggests that the impact will be small and short-lived.

Even if the disaster scenarios fizzle, defensive economic behavior could lead to a recession.

But even if the optimists are largely right – even if the computer glitches have only a modest direct impact on production and distribution – anticipatory behavior by households and businesses could have some surprising consequences. We at WEFA expect Y2K to keep the economy growing faster than expected in 1999, but the end of the year could be wild. Indeed, those nostalgic for the 1970's can even look forward to the return of gasoline lines and spot material shortages. Then, at the beginning of the new millennium, companies will want to work off inventories, and growth will lag badly.

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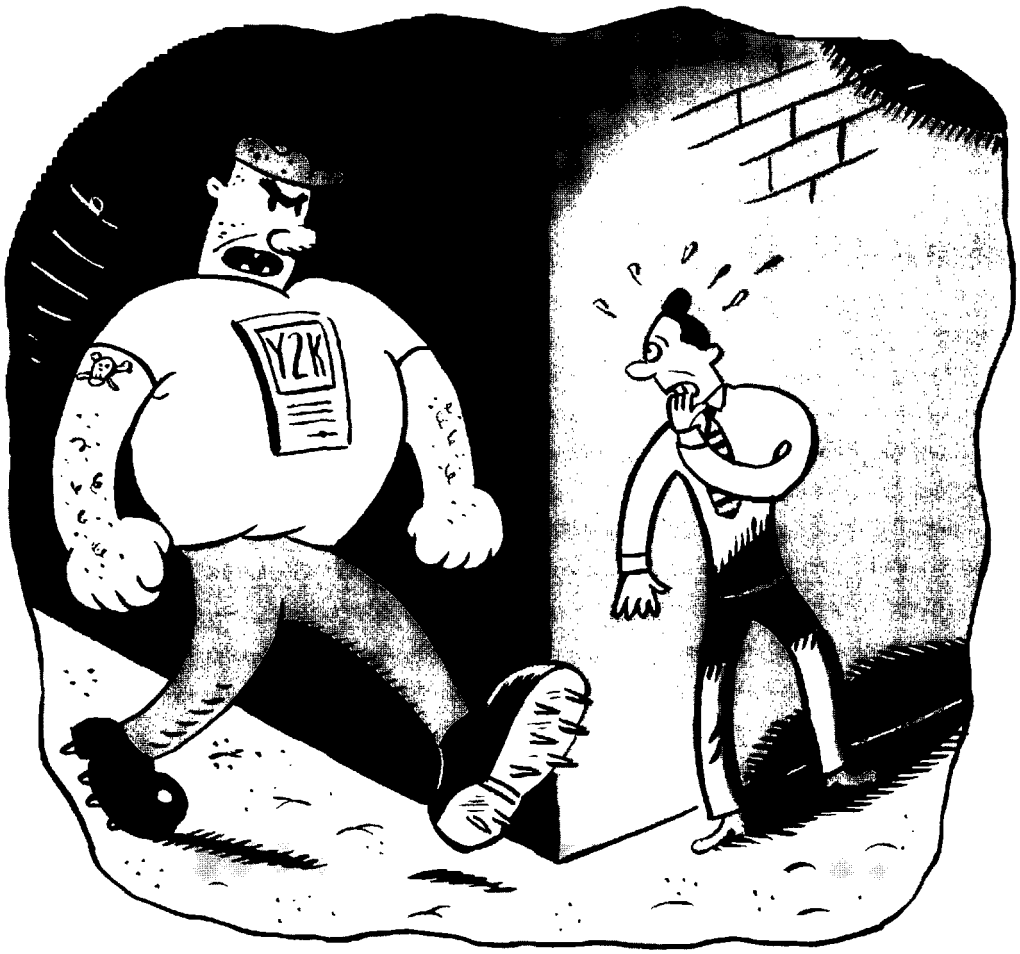

MARC ROSENTHAL (3)

Of course, major supply shocks à la Yardeni that reduce productive capacity for some time are not out of the question. And such shocks, major or minor, could be greatly amplified by ongoing questions of legal liability.

HOW Y2K CHANGES THE ECONOMIC OUTLOOK

It's easy to make the optimists' case. Y2K pessimists generally underestimate the degree of redundancy build into a competitive economic system. They also overestimate the importance of big computerized systems in the functioning of the economy.

The role of the air traffic control system is a good example. If, in fact, the integrated network of radars and computers does fail on Jan. 1, airplanes will not fall out of the sky. Other systems, allowing decentralized tracking by individual airports and aircraft, will keep the planes flying. Continuing failure would force airlines to reschedule flights, and the total capacity of the system would surely fall. But air travel is very unlikely to come to a halt.

This is no guarantee that Y2K-related disruptions won't be serious or difficult to unwind. It does suggest, however, the inher-

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ent difficulty in analyzing their macroeconomic impact. We at WEFA have thus chosen to focus on factors that are important, but easier to pin down. We concentrate on the behavioral impact of economic actors faced with the uncertainty inherent in Y2K. And we identify one general rule for analysis and six major points at which the bug could affect the broader economy.

SIZE MATTERS

Our rule is simple: the larger the organization, the less likely it is to fail. Large organizations generally have the resources and awareness to manage the problem. Indeed, the managers of very largest systems, such as the electricity supply system, have long been aware of the issue and have already sunk substantial resources into minimizing the consequences of failures or preventing them altogether.

By contrast, many small organizations will fail or be forced to operate without electronic information. The failure of a small bank or company can occur (and does dozens of times a day) without unduly affecting the economy. Moreover, small organizations can more easily dodge the Y2K bullet because they are less dependent on computers for storing information. One tiny credit union we know considered a simple fallback plan: ledger books and pencils.

The organizations at greatest risk, then, are the ones in the middle. These are the organizations that can't do without electronic data management, but may not have the resources or management to cope with Y2K retrofitting.

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The good news is that such organizations are mostly private firms in competitive markets. Thus failure generally means that their trade goes elsewhere – a prospect that is hard on the firm's owners, but of little consequence for the rest of us.

Y2K could thus accentuate natural selection in the market, sorting out managers who can rise to the challenge from those who cannot. Companies that successfully continue to operate in the new millennium will grab larger market share and possibly control of their rivals. We know of one mutual fund that is actively seeking investments in well-managed companies and that intends to sell short the stock of their poorly managed competitors. While civilization won't end, some of the corporate artifacts of modern capitalism will probably succumb to the millennium bug.

IMPACT POINT 1: THE PAYMENTS SYSTEM AND FINANCIAL MARKETS

The financial system is the largest information system in the world. Our rule applies fully here, because financial markets and institutions have long been aware of the problem and have probably spent more money than any other industry to contain it.

Wall Street's worst nightmare is a sudden halt in trading. This could happen if software used directly in trading failed, or if banks and other middlemen were unable to confirm and record transactions. The financial system is heavily dependent on computerized systems to operate smoothly, and institutions are cross-linked so that failure of any big wire house to clear transactions could bring down the whole show.

The Federal Reserve has plunged into the problem, however, using its extensive regulatory authority to force the major market players to test their systems and make corrections.

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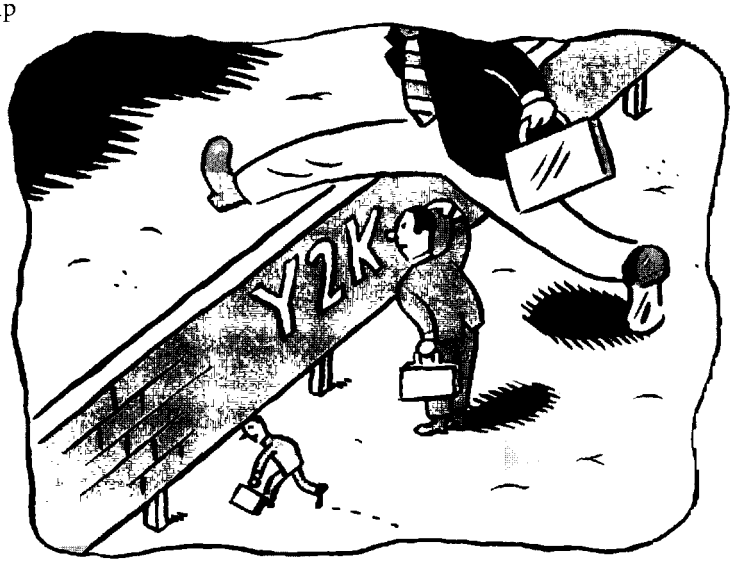
The Fed has almost completed its own internal systems review. Initial simulations have already been carried out on both the Fed's inter-bank systems and on other securities trading systems. Individual banks and financial firms will probably slip through the cracks, but the system as a whole should be sufficiently robust to support trading as the century turns.

Beyond the payments system, however, there are several areas in which the Fed must tread carefully. The specialized financial media will certainly recommend that households have extra cash on hand at the beginning of the year, and people probably won't need much prodding. Can you really be sure ATM's will work on Jan. 1? The Fed is printing tens of billions in extra currency to cover this demand – and, incidentally, has to figure out how to store and distribute all that cash.



big + small companies can get through it — MID SIZE have the most trouble

If the mint's printing presses don't cover the problem, the Fed also has ways of conserving the currency stock – for example, by turning it around faster when it comes back to the regional Federal Reserve banks. Absent sufficient currency, the Fed will probably look the other way at informal credit and voucher systems that take the place of scarce legal tender.

Cash withdrawals, of course, drain reserves from the banking system. To keep banks solvent, the Fed will presumably be ready to replenish their coffers, most likely by purchasing Treasury securities on the open market.

Banks face unique problems in planning for the millennium – problems that go beyond insuring that their computer systems work. Identifying the Y2K-related risks in borrowers is a daunting task. Conservative bankers will therefore strongly prefer to be in T-bills than in loans at the end of the millennium, even where the potential borrowers have strong credit ratings. Public-private interest rate spreads are likely to jump at the end of 1999, and even longstanding customers may find credit hard to obtain. Remember, too, that this short-term credit crunch will come at the moment many companies will need capital to build inventories. Banks may also restrict consumer loans, since the short-term outlook will be particularly uncertain at the end of the year.

This situation will cry out for extensive Fed action to keep the economy awash in cheap credit over the period. Yet, since economic growth is likely to be above the long-term growth rate of capacity at the end of 1999,

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Fed decision-makers will have to be ready to move counter to conventional monetary policy wisdom. We hope they do, as the New Year will very probably bring an economic slowdown when the anticipated inventory cycle comes full circle.

IMPACT POINT 2: INVENTORY ACCUMULATION

By late 1999, newspapers, magazine and television will be brimming with advice to keep groceries on hand "just in case" – and survivalists will be joined by the rest of us.

Businesses will seek to do the equivalent, which means that inventories are likely to soar in late 1999.

How much extra inventory will be needed? With very conservative assumptions, we estimate that companies will add 4 percent to base-level inventories by the end of the year. And substantially greater accumulation is possible. Inventories currently cover 42 days of production and sales. Thus increasing coverage by one week, on average, would require a 17 percent rise. And that would almost certainly create a mini-boom-and-bust, as businesses ran down the excess once they were over the Y2K hump.

This mini-cycle would occur even if Y2K turns out to be an insignificant technical problem. For it is the expectation here – not the reality – that counts.

Consumers will contribute to the inventory buildup, too. Aside from groceries, they will probably top off their gasoline tanks – or at least try to – on Dec. 31. Meeting this blip in demand would be a staggering task for the distribution system, so gas lines in the last few days of 1999 are in the cards. Even if Y2K generates no enduring supply disruption, consumer purchases in anticipation of the end of the year followed by a rundown in consumer inventories will create a mini-cycle in spending that will feed the larger business inventory cycle.

IMPACT POINT 3: EMBEDDED CHIPS

Chips now show up all over – even in farm animals. And it will not be possible to identify and fix all the Y2K-vulnerable ones before the end of 1999. This certainty has provided the doomsday economists with grist for panic (Your car won't start! Your pacemaker won't work!), much of which is groundless.

Most microprocessors outside conventional computers don't track dates, and many that do can function adequately without dates. Indeed, the Gartner Group, a consulting company that has been on the pessimistic side of the Y2K problem, estimates that just two-tenths of a percent to 1 percent of all embedded chips are not Y2K-compliant.

In many cases where dates do matter, the Y2K problem can be overcome easily. And in most others, the damage will be self-limiting: the failure of one manufacturer or retail chain in a world of decentralized markets does not endanger the entire economy.

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The electricity distribution grid, which is highly centralized, is often cited as the largest area of concern. But problems in power distribution are less frightening than they first appear. Recent disruptions in New Zealand and Quebec had no discernable macroeconomic impact. And while economists are not competent to judge the engineering issues involved in maintaining the power grid, there doesn't seem to be evidence that the system is sufficiently vulnerable to cause a recession-size shock.

IMPACT POINT 4: INVESTMENT SPENDING

An easy way to insure Y2K compatibility is to buy new equipment. It is so easy, in fact, that we expect investment spending to remain stronger than would otherwise be expected in 1999. There will be a surge in orders of producers' durable equipment as companies realize that the best defense against the Y2K problem – whether in embedded chips or in computers – is to accelerate their investment plans. Indeed, recent growth in spending on information processing equipment may already reflect a sense of urgency.

Strikingly, Federal Reserve economists have predicted that investment spending will slow in the second half of 1999 because companies will not want to rock the boat with new equipment before the millennium. Since the new equipment is sure to be Y2K compliant, however, and since many companies have not yet felt compelled to fix the problem, we think a surge in orders is much more likely than stagnation.

While this looks like good news for capital equipment makers and the economy, it runs head-on into current economic trends. As of the end of 1998, many United States corporations were pulling in their horns, expecting a slowdown or recession in 1999. At WEFA, we don't expect a recession. But a decline in investment spending could leave more companies vulnerable on Jan. 1, 2000. And panic buying in mid-1999 is possible as businesses belatedly realize they need new equipment.

IMPACT POINT 5: GOVERNMENT FINANCES

While competitive markets insure that the economy will continue to operate, the centralization of the Federal Government is more worrisome. Washington has its fingers in many economic pies, adding to demand through transfers and vendor payments and siphoning away demand through tax collections. Both types of transactions could create problems large enough to affect the economy.

On the spending side, Federal transfers – everything from Social Security to Medicaid – account for 13 percent of disposable personal income. If the checks don't go out, consumer demand would certainly fall.

Of course, it would be a political disaster if Social Security payments stopped, so we expect the checks to be in the mail even if the President has to sign them by hand. Payments to workers and contractors, however, could easily be delayed, and the backup in payments through the supplier chain could add a few twists to the credit and spending crunch in the months after the New Year. A handful of industries – notably health care with about one-quarter of revenues coming directly from the Federal Government – will be at greatest risk.

Problems on the income side are rather different. The Government should continue to receive revenue since the banking system is likely to operate smoothly. The failure of the I.R.S.'s computers would create chaos in processing forms, but wouldn't block collections.

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The failure of the Treasury's accounting systems, however, could cause Washington to lose track of how much was actually in the bank. And this could increase uncertainty in already-tense credit markets, with the Federal Government issuing short-term debt even as its assets pile up in bank accounts.

Failures at the state and local levels are possible, but here the rule of size comes into play: Larger cities and states have the resources to solve Y2K-related fiscal problems; smaller jurisdictions may fail, but their failure is unlikely to lead to economic collapse. A school board unable to generate paychecks by computer could probably issue them by hand. A city unable to process property taxes for several months might need a bridge loan. With the national payments system on track, however, and a Fed that is willing to supply sufficient credit, such problems should not lead to economic disaster.

IMPACT POINT 6: THE FOREIGN TRADE SECTOR

Foreign countries are behind the United States in coping with Y2K, creating two areas of concern. First, the United States financial system is tied into others, both through software connections for payments clearances and through financial institutions that manage the web of credit supporting trade and investment. The resulting risks to the payments system are real, but probably can be contained because the Fed and large banks are well aware of them. It is therefore unlikely that our wire transfer mechanism would crash simply because the Germans or the Swedes didn't have Y2K-friendly systems.

The real economy, however, provides room for some dramatic shifts in trade flows and exchange rates. United States companies building inventories will be particularly sensitive to the prospect of disruptions from foreign suppliers because overseas manufacturers are behind the United States in Y2K remediation. This suggests that an import surge in 1999 is quite likely, one parallel to the stockpiling of domestically made goods. Foreigners may also increase orders of United States goods, leading to an export boom at the same time.

Financing the import surge should not prove difficult as international investors, leery of the Y2K competence of foreign banks, will want to shift portfolios toward the United States at about this time anyway. International capital flows are generally larger and more flexible than goods flows, so the dollar should appreciate even as the trade balance weakens in late 1999.

After the first few months of 2000, the import surge will reverse. Not only will United States companies want to use up the stockpiles of imported goods, but foreign suppliers suffering from Y2K-related problems will be less able to fill orders. While this might initially make United States companies more competitive in global markets, Y2K problems abroad may offset the impact by reducing demand overall.

Meanwhile, capital will presumably start to drain from the United States, as the uncertainly surrounding Y2K evaporates. The capital movements point to dollar depreciation, but this is not inevitable. If European or Japanese financial systems are disrupted, hot money may remain in the United States for some time after the turn of the century.

THE ECONOMIC OUTLOOK WITH Y2K

Figure 1 compares WEFA's forecasted growth of gross domestic product for 1999 and 2000, with and without the Y2K phenomenon. The

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contrast is startling: We expect Y2K to keep the economy growing in an otherwise weak economic environment through 1999. Indeed, inventory accumulation, along with additional investment in computer fixes and a burst of exports, will push growth above the long-term sustainable growth rate of 2.3 percent in the second half of the year.

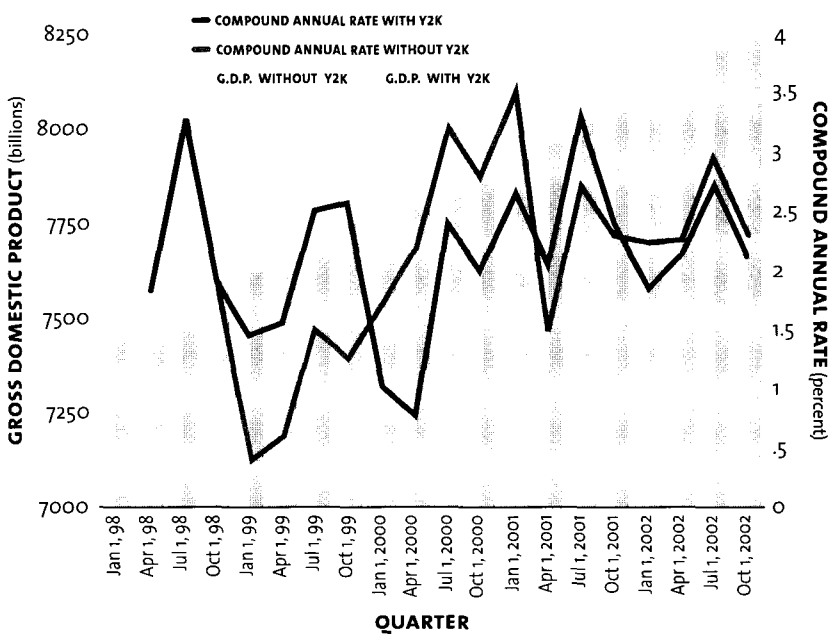
Once Jan. 1 rolls around, however, businesses will move back to normal inventory and investment behavior, which will include running down the extra inventories amassed as a precaution in late 1999. Growth is likely to soften significantly.

The figure shows WEFA's most recent forecast for G.D.P. growth with and without the Y2K impact. Without the Year 2000 impact, economic growth would slow considerably in 1999. Y2K will help to keep the growth rate up and accelerating through the end of 1999. By early in the year 2000, however, the millenium bug problem will pull growth down as inventories are run down.

Some observers argue that Y2K will reduce growth in 1999 because they confuse potential output with aggregate demand. Under our assumptions, Y2K reduces productive capacity by one-tenth to three-tenths of a percent, largely because computer software and hardware will depreciate more quickly than expected. In the short run, however, the important impact will come from spending to replace the depreciated capital, as businesses defend themselves against the risk that suppliers will not be able to fill orders after the millennium bug hits. Thus, Y2K will clearly add to G.D.P. growth in 1999.

The resulting press on production in 1999 will lead to spot shortages and, almost certainly, a spike in inflation at the end of the year. This should be transitory, however, abating after the New Year.

THE IMPACT OF Y2K ON THE G.D.P.



SOURCE: WEFA, Inc.

LONG-TERM ISSUES

We at WEFA expect Y2K to generate a supply shock akin to, say, the energy crisis of 1973-74, although not nearly as large. But it will also generate legal uncertainty about liability for disruptions, a factor that could do far more serious damage to the economy.

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PRODUCTIVITY GROWTH AND COMPLIANCE COSTS

From the economic model-builder's perspective, Y2K amounts to a sudden depreciation of the capital stock: physical capital that might have lasted longer will need to be replaced because it will not work properly after Jan. 1, 2000. For the same reason, the "intellectual capital" embodied in software must also be replaced earlier than planned.

But the total depreciation involved is not enormous. The Fed, using data from Securities and Exchange Commission, guesses that United States companies will pay on the order of $50 billion to fix the Y2K problem, not including hardware expenditures. As a benchmark for comparison, note that the private physical capital stock in 1996 totaled $16.5 trillion. The total stock including intellectual capital is obviously much larger. The depreciation implied by Y2K is thus on the order of three-tenths of a percent of the physical capital stock. The Fed estimates that the supply-side impact on G.D.P. will be a tenth of a percentage point of growth in 1998 and 1999, small enough to be lost in measurement errors.

Nevertheless, an anticipated productivity shock is a signal event. Indeed, the behavior of the economy in this period may help to advance the debate on the heretofore-esoteric economic theories of "rational expectations" and "real" business cycles. Should an anticipated supply shock create a business cycle? Only your friendly neighborhood economic theorist knows.

THE LIABILITY TIME BOMB

At WEFA, much of our (relative) optimism for the economy in 2000 is based on our size rules. With failures concentrated in small and medium-sized enterprises, a well-functioning financial system should allow prepared companies to absorb the assets of the losers relatively quickly, allowing a smooth transition to the post-millenium bug world. The well-known American inclination to settle diputes in court, however, suggests that such optimism may be unwarranted.

Who is liable for Y2K failures? Software vendors, insurance companies and industrial suppliers will blame one another, making their cases in large, expensive lawsuits. Worse, the huge financial stakes will almost certainly dictate protracted settlement negotiations. The most enduring damage from Y2K could thus come from tying up substantial capital in bankrupt companies. We did not include an impact of these legal problems in our simulation, but it remains perhaps the scariest Y2K problem of all.

SELF-FULFILLING PROPHECIES

The end of a millennium should have no meaning for economists. But 2000 will be different, because of the millennium bug. Check that: The bug itself may not prove serious, it is in how we react to the prospect of disruptions. Modest attempts by businesses and households to protect themselves against the bug could have a large economic impact – as could the Fed's response to rational defensive economic behavior.

Ideally, the Fed will keep credit very plentiful over the transition, even if Y2K brings with it evidence of incipient inflation and material shortages. The shortages will no doubt be brief. However, since continuing credit shortages linked to ill-defined legal liabilities are a real possibility, the Fed should be prepared to keep the credit spigot open well into the year 2000. M

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Capital Mobility

Ties Need Not Bind

By Barry Eichengreen

Since the Asian crisis erupted, Indonesia has been wracked by unrest and President Suharto has been driven from office. But in neighboring Malaysia, Prime Minister Mahathir Mohamed responded to the same crisis in a radically different way, imposing a curfew on capital rather than on unruly students.

Imported capital helped fuel the great boom in East Asia. But capital flight now threatens to drive emerging markets back to poverty. Is there a way to save the baby while jettisoning the bath water?

Once the home of wide-open financial markets and a highly capitalized stock market, Malaysia now controls both purchases and sales of its currency. Not just banks and stock brokers are affected: Citizens are prohibited from taking as little as $100 out of the country, and the law is enforced by random searches at the airport.

Mahathir argues that this infringement on civil liberties, the financial equivalent of a dusk-to-dawn curfew, is needed to protect Malaysia from marauding hedge funds that mug innocent bystanders. It would be madness, in his view, to leave currency speculators unrestrained, jeopardizing the health of the economy.

Capital controls, it seems, are back in fashion. Paul Krugman of M.I.T. recently argued in *Fortune* magazine that emergency conditions warranted emergency

SCOTT BALDWIN (4)

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measures. Asserting that the Asian countries experiencing the crisis were collapsing, he urged them to consider controls as shelter from the storm. His argument was seen, rightly or wrongly, as giving Mahathir intellectual cover for his unorthodox initiative. Meanwhile, Dani Rodrik of Harvard issued a blanket indictment of capital market liberalization. Rodrik asserted there is no evidence that countries allowing free capital flows actually grow faster, while it was self-evident that international liberalization exposed them to financial panic.

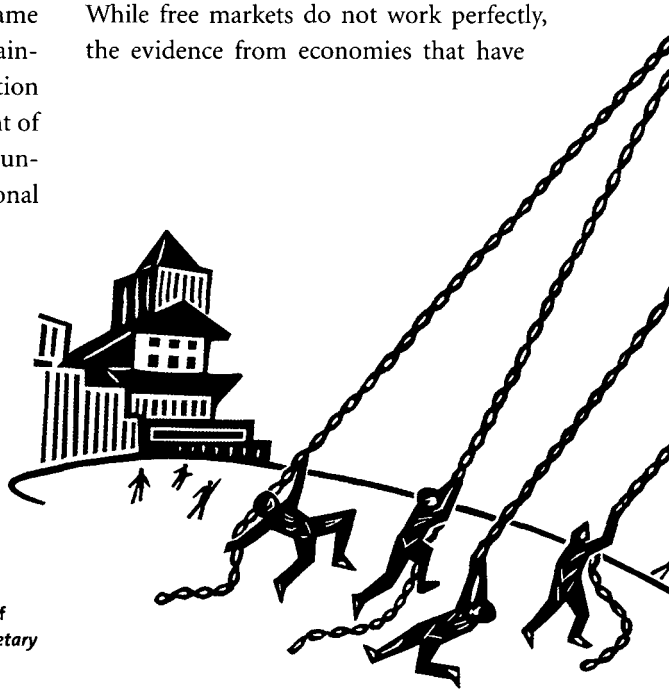
This apostasy, flying in the face of all that is sacred to economists, has predictably provoked harsh criticism. Economists presume that markets know better than governments and that, left to their own devices, markets allocate resources reasonably well. Yet the suspicion remains that there is something different about international financial markets.

Harry Dexter White and John Maynard Keynes, the founding fathers of what became known as the Bretton Woods system, certainly thought so. While supporting liberalization in principle, the Bretton Woods Agreement of 1945 permitted – indeed, encouraged – countries to retain restrictions on international financial transactions. Only in recent years, in response to pressure from the International Monetary Fund and the United States, have governments (first in Europe and Japan, and later in most emerging markets) abandoned capital controls. The Asian crisis suggests that at least in the case of developing economies, this was a serious mistake.

Stepping back a bit, it is far from clear why international financial transactions should be treated differently from other transactions or why the presumption that markets know better than bureaucrats is invalid. Is the operative word here "financial" or is it "international"? Are capital controls simply to be tolerated as emergency measures, or should they be retained as permanent protection against fickle investors? Should they be on the agenda of all relatively open economies or only emerging markets? Unfortunately, the discussion to date has confused these issues more than it has illuminated them.

THE FUNDAMENTAL CASE FOR FINANCIAL LIBERALIZATION

Perhaps the most basic insight of modern economics is that self-interested economic actions maximize collective interest – or, to put the point more simply, that markets allocate resources in socially desirable ways. While free markets do not work perfectly, the evidence from economies that have



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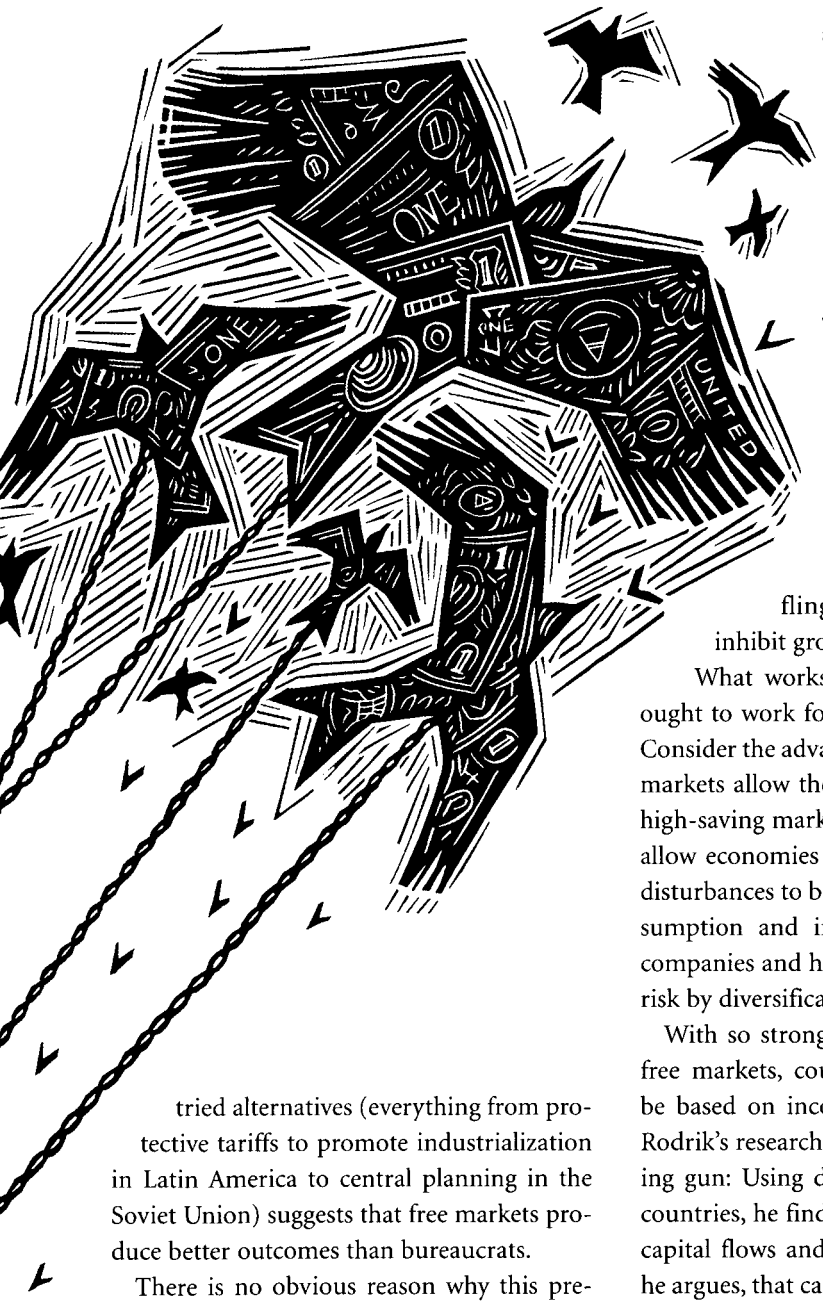

tried alternatives (everything from protective tariffs to promote industrialization in Latin America to central planning in the Soviet Union) suggests that free markets produce better outcomes than bureaucrats.

There is no obvious reason why this presumption should apply less to financial markets than to other markets. Indeed, studies by the World Bank have consistently shown that countries with more developed financial markets grow faster. By the same token, experience with policies of repression in developing countries and with state monopolies over transactions in the former Soviet bloc shows that stifling financial markets can inhibit growth.

What works best for domestic finance ought to work for international finance, too. Consider the advantages: international capital markets allow the transfer of resources from high-saving markets to low-saving ones; they allow economies experiencing business-cycle disturbances to buffer abrupt changes in consumption and investment, and they allow companies and households to protect against risk by diversification.

With so strong a presumption in favor of free markets, counter-arguments had better be based on incontrovertible evidence. And Rodrik's research is widely cited as the smoking gun: Using data from a cross-section of countries, he finds no statistical link between capital flows and economic growth – proof, he argues, that capital mobility has not driven

Free markets produce better outcomes than bureaucrats.

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economic development.

Well, hardly proof. Statisticians may fail to find a relationship between capital account liberalization and growth, not because none exists but because they have inadvertently omitted other variables that are negatively associated with growth but positively associated with the political decision to open capital accounts. It is plausible that countries deciding to keep their capital accounts open differ in other ways – including ways which statisticians cannot account for.

The secret of empirical work is to define your hypothesis so that failure to find significant results can be interpreted as support.

The Rodrik research is thus what Jeffrey Frankel of the President's Council of Economic Advisers refers to as "fail-safe" econometrics. In his words, "the secret of empirical work is to define your hypothesis so that failure to find significant results can be interpreted as support."

In a sense, those who argue that today's developing countries should reject capital mobility are adopting something of a double standard. All of today's advanced industrial economies have opened their capital accounts. And all of them have made their currencies convertible for purposes of investment. This is the logical culmination of developing a deep, mature and efficient domestic financial system. For domestic and international financial liberalization do go together: It is very hard to liberalize domestic financial transactions, yet keep a lid on cross-border transactions. Some would go a step further, arguing that capital account liberalization is part and parcel of political liberalization. Capital controls, needless to say, infringe on economic freedom and are not a regime under which most readers of this article would themselves prefer to live.

But absolutists on both sides miss some critical nuances. I would agrue that it makes sense for developing countries to control capital flows while they build diversified financial systems, upgrade supervision and strengthen their monetary and fiscal institutions. These should be transitional measures, though: there is no better case for permanent control in developing economies today than in the now-rich economies that wrestled with similar problems long ago.

CAPITAL CONTROLS AS PRUDENTIAL MEASURES

Markets may be the best means we have for allocating financial resources, but history has also shown that they can be dangerously unstable. Like a trapeze artist, the financial system can perform miraculous tricks, yet experience catastrophe if allowed to perform without a net.

Banks in particular share the circus performer's vulnerability. Their investments are almost invariably less liquid than their deposits. And they must operate with less-than-perfect information. Indeed, one of

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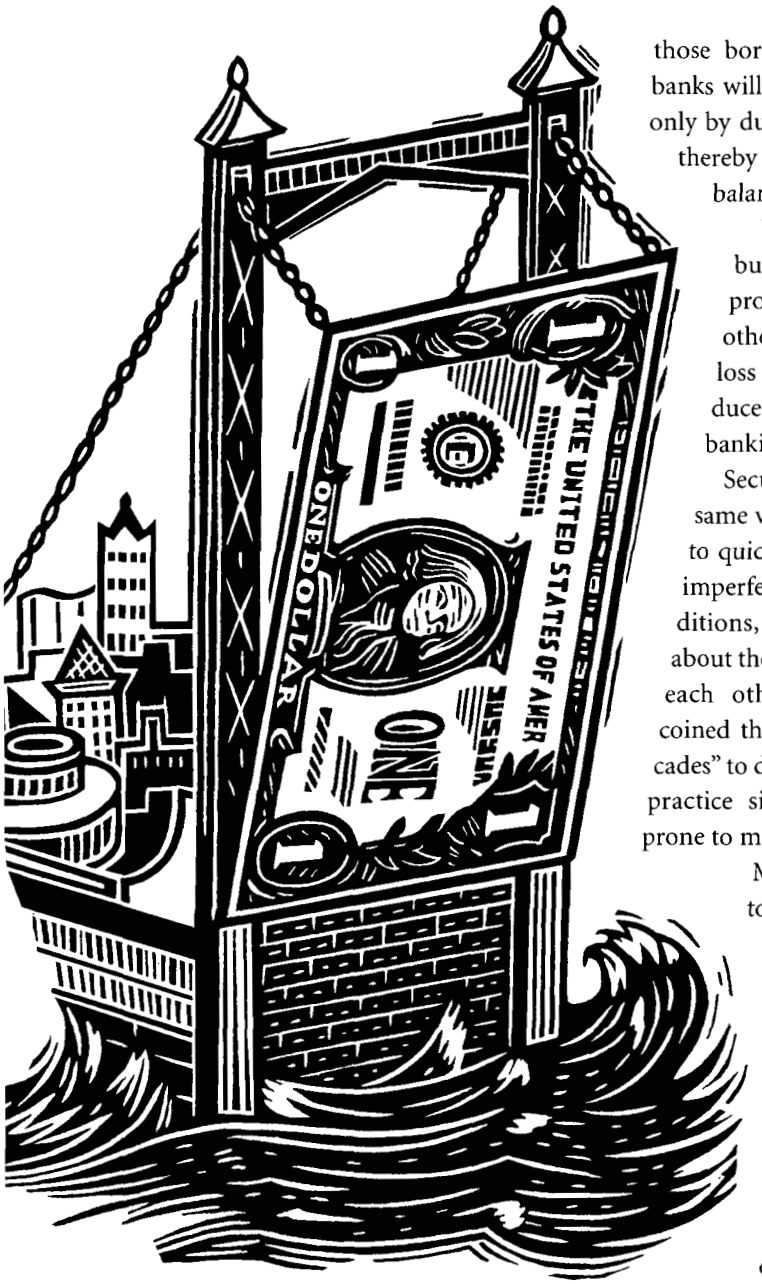

their basic functions is to develop long-term relationships with clients as a way of acquiring information about their borrowers' credit worthiness.

But the reality that other potential creditors will not have equally good information about those borrowers virtually guarantees that banks will be able to raise funds in a crisis only by dumping assets at fire-sale prices – thereby doing further damage to their balance sheets.

What's more, banks do extensive business with one another. Hence, problems in one create problems in others. For all these reasons, a sudden loss of depositor confidence can produce a panic that brings the entire banking system to its knees.

Securities markets share many of the same vulnerabilities. Investors are prone to quick, collective reactions. And being imperfectly informed about market conditions, they tend to make inferences about the real value of their securities from each other's actions. Economists have coined the elegant term "information cascades" to denote this phenomenon, which in practice simply means that investors are prone to moving in herds.

Moreover, investors often borrow to increase their financial leverage, so that when markets move against them they must put up additional collateral. They can thus be forced to sell into a falling market, amplifying price volatility. And a large price fall can bring commercial lenders down, threatening the flow of credit for the "real" economy. The case of Long-Term Capital Management reminds us that this scenario is not merely hypothetical.

That's why governments impose ceilings on concentrated investments and positions in foreign exchange, and why they limit the amount of margin money that stock buyers are allowed to use. And that's also why they do

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not allow banks to walk the high wire without a net – typically, a combination of deposit insurance and access to a government lender of last resort.

Open and unregulated international capital flows pose special risks in this context. If banks borrow in foreign currency, they undermine their regulators' ability to act as lenders of last resort. After all, a central bank can't print foreign currency, and its capacity to provide commercial banks the foreign exchange needed to make good on their foreign obligations is limited to its own reserves of foreign currency.

Even if private bank debts are all owed in domestic currency, a central bank trying to defend the exchange rate in the midst of a crisis will find itself between a rock and a hard place. It must choose between draining liquidity from the markets (raising interest rates) to defend the exchange rate or injecting liquidity (lowering interest rates) to defend the banks.

Don't misunderstand: In a well-working market economy, risk management is first and foremost the responsibility of bank owners and managers themselves. They are the ones making the investment decisions, and they should bear the consequences. Indeed, the best reason to force banks to hold capital reserves is to guarantee that their owners have something to lose from bad decisions.

Regulators form a second line of defense against excessive risk-taking. They can monitor banks balance sheets and take corrective action when they find fraud, incompetence or evidence that bank owners are taking huge risks to dig their way out of insolvency.

But where risk-management practices are underdeveloped and the regulators lack political will or administrative capacity, it usually makes sense to build a third line of defense – to limit risk-taking by limiting the banks' ability to borrow abroad. And where corporations can borrow abroad without banks as intermediaries, it may be necessary to control all capital flows – or tax them, the way Chile does.

After Mexico in 1994 and Asia in 1997, do we need a third reminder of the dangers of premature financial liberalization?

Capital controls can only be justified as a means of containing risk if they do not arbitrarily discriminate in favor of some borrowers – say, the finance ministers' children – over others. Moreover, they are justifiable only where financial markets are thin, the private sector's risk-management practices are underdeveloped, and the regulators' capacity to supervise the financial sector is limited — in other words, where the conventional defenses against systemic risk are inadequate. In practice, though, these last three conditions (and therefore the argument for capital-inflow controls), apply to the vast majority of developing countries. Wide-open capital accounts should be the exception in emerging markets, not the rule.

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Eventually, financial markets will deepen, bankers will learn to manage risk and regulators will gain competence and independence. At that point, restrictions on foreign borrowing should be removed. But here, as in other forms of financial regulation, it is smart to err in the direction of caution – to be certain that the system works before opening the doors to foreign capital. After Mexico in 1994 and Asia in 1997, do we really need yet a third reminder of the dangers of premature financial liberalization?

CAPITAL CONTROLS AS EMERGENCY MEASURES

From Thailand to Indonesia to Korea to Brazil, countries have been forced to respond to panic and the resulting recessionary pressures by cutting their budget deficits – not by increasing them, as the textbook Keynesian advice would suggest. The single greatest insight of the Keynesian revolution, namely the importance of fiscal stabilizers, has thus been thrown out the window.

Some (like Jeffrey Sachs of Harvard) say this simply reflects bad advice by the I.M.F., which required budget cuts in Asia as a condition for official loans, and which is now demanding the same of Brazil. In fact, the fund is merely mirroring market sentiment. If a country like Brazil were to respond to slower economic growth by cutting taxes and increasing public spending, investors would flee, the currency would crash and the resulting financial distress would only make the recession worse. Thus, market discipline is perverse. As Paul Krugman puts it: "Brazil, we are informed, must suffer a recession because of its unresolved budget deficit. Huh? Since when does a budget deficit require a recession?"

This bizarre state of affairs explains in part why Mahathir imposed capital controls: without restraints on capital flight, Malaysia could not use expansionary fiscal policy to offset recession. And it is the argument that has led otherwise-orthodox free marketers to advo-

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cate controls in the teeth of crisis.

Controls do have costs: they require a burdensome administrative bureaucracy, reduce the pressure for policy reform and interrupt access to foreign sources of investment finance. But their benefits may still dominate if they restore the efficacy of expansionary policy tools.

Whether this is a sensible argument hinges on how markets view government efforts to stimulate the economy. If investors are inclined to panic when the government activates its macroeconomic stabilizers, it can be sensible for countries to use controls to contain their individually rational but collectively destructive behavior. If, on the other hand, investors respond negatively because they view controls as the government's substitute for tough, enduring reform, then the only practical response is for the government to clean up its act.

The latter argument goes like this. Some governments lack fiscal discipline and are perennially coping with the consequences. Like an overweight man, they are continually trying to teach themselves to stay away from the refrigerator. If the fat man says, "I've had a lousy day; I'm going make myself feel better by having a piece of cake," his friends are likely to revise their estimates of the likelihood that he will stick to his diet.

Likewise, governments with a history of fiscal laxity that have a lousy macroeconomic day and respond by increasing their budget deficits similarly run the risk of being re-evaluated in this way – of being seen as having reverted to their bad old habits of living beyond their means. And if investors expect budget deficits to be financed by printing money, then deficits today imply inflation tomorrow, encouraging the rational investor to take the first opportunity to get his assets out of the country.

This explains the paradox that deficit spending in the United States strengthens the currency while deficit spending in Brazil weakens it. In the case of the United States, no one expects the Fed to print money to cover the budget deficit. Hence, additional government spending pushes up the exchange rate along with interest rates, as investors buy dollars for the higher return. In the Brazilian case, however, monetization is a real possibility (pun intended), implying more inflation and ultimately the need to allow the currency to depreciate.

Pragmatism is the order of the day. Developing countries are simply not ready for prime time.

It is also why another textbook response to recession – devaluing the currency in order to increase demand for goods made at home – can have catastrophic effects in emerging markets. Countries weaning themselves from inflation often do so by pegging the exchange rate, which ties the hands of the central bank and signals that the inflation will no longer be the path of least resistance. The currency peg

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is thus the metaphoric lock on the refrigerator. And countries that devalue are seen as candidates for relapse to inflationary excess.

The best solution in this latter case is not to impose capital controls but to eliminate the problems leading to the excesses in monetary and fiscal policies in the first place. And the most convincing way to signal that future policies will be sound is to reform the economic and political arrangements by which they are made.

A slew of research shows quite convincingly that better policy-making institutions produce better outcomes. Not surprisingly, central banks that are insulated from politics are better able to resist popular pressures to finance budget deficits the easy way – by running the printing press – and are generally more successful at stabilizing prices.

There are parallel arguments for creating an independent national fiscal council constitutionally empowered both to set a ceiling for the government budget deficit and to enforce the budget discipline. By the same token, less ambitious reforms that vest more fiscal power in the hands of the prime minister or finance minister (thereby eliminating the nobody-in-charge syndrome common to governments with autonomous ministries) are statistically associated with smaller deficits. Even measures that enhance the transparency of budgeting, making it easier for voters to identify the fiscal culprits, are likely to produce better outcomes.

With such reforms in place, markets will not conclude that deficits today necessarily mean deficits tomorrow, or that monetary expansion today means monetary expansion tomorrow. Indeed, the discretion to use fiscal and monetary policies as a counterweight to the business cycle will be regained, and capital mobility will no longer be a disaster waiting to happen.

Rewriting the rules to deliver better outcomes needn't take forever. A simple law – or better, a constitutional amendment – establishing the independence of the central bank, appointing its governors to long terms in office and reining in the fiscal autonomy of the spending ministries can be adopted in short order.

Time may be required for the new institutions to establish a track record of delivering sound macroeconomic policies. Still, Argentina's example suggests that this can be accomplished in a matter of a few years. Argentina, after all, moved from being an inflationary basket case and a capital-market pariah to one of the few emerging economies able to float bonds on international markets and to avoid excessive belt-tightening in the global turbulence of 1998.

What, then, are we to make of the debate over capital controls? Pragmatism is the order of the day.

Developing countries are simply not ready for prime time. Their regulators lack administrative ability. Their financial markets are shallow. They cannot borrow abroad in domestic currency. And so long as these problems are defining features of emerging markets, there will be solid arguments for capital controls to limit risk and to make room for monetary and fiscal stimulus in a slump.

With time, though, developing countries do develop. Their financial and regulatory institutions become more robust, and the case for capital controls grows ever weaker. Indeed, while it is true that premature liberalization has proved costly in Asia and Latin America, it would be a sad irony if capital controls become an excuse for slowing the institutional reforms so critical to insuring their long-term prosperity. M

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Mis-Planned Parenthood

The Unintended Consequences of China's One-Child Policy

By Nicholas Eberstadt

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PAUL CONKLIN/MONKMEYER

Over the next generation, China's changing landscape – political, economic and perhaps social as well – will have profound and far-reaching implications for the rest of the world. Yet in most important respects, the future face of this rising power is obscure.

China's economy, for example, will surely be large: By the World Bank's "purchasing power" method of calculation, it is already the second largest in the world. But the economy's productivity and global standing are deeply uncertain. Much the same can be said for such basic matters as system of government and the character of its foreign policy. There is one important aspect of China's future, though, that can be described with some accuracy: the makeup of the population a generation down the road.

In the next several decades, China's demographic patterns will be driven by two fundamental realities. First, despite relatively low living standards, contemporary China has attained long life expectancy. Second, and even more important, fertility is now remarkably low – below the level necessary for long-term population replacement – and unlikely to increase substantially.

Slowing population growth by force seemed a no-brainer to the tough, pragmatic heirs to Mao, who were determined to bring China into the modern age. Little did they foresee the mess this policy would create for their heirs.

Contemporary China's mortality and fertility patterns have been strongly influenced by the persistent and often muscular interventions of its Communist Government, the most notable being the "One Child Norm" campaign ostracizing larger families and penalizing them financially. More so perhaps than anywhere else on the globe, planners in China have presided over a reconstruction of their country's demographic rhythms.

There is considerable irony here. For in laboring to avoid one set of population problems, Beijing has insured that another, arguably more daunting, set will emerge in the decades ahead. These problems will be without precedent in the Chinese experience.

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Some, in fact, have no precedent anywhere. And at this point it is impossible to foretell their impact.

Enlightened policies or cultural change could soften the blow. But there is little doubt these remarkable demographic problems will impede economic growth, exacerbate social tensions and complicate Beijing's quest for national power and security.

THE SHAPE OF THINGS TO COME

How is it that we can already have a clear impression of China's demographic profile a quarter-century from now?

Like a supertanker at full steam in open seas, large populations cannot change course swiftly. Thus, even when patterns of childbearing or longevity shift suddenly and radically, it takes many years for the changes to alter a population appreciably.

Most people who will probably be living in China a generation from now are already alive.

Moreover, thanks to the particulars of its present age structure, fertility levels and mortality outlook, we can peer deep into China's demographic future. The reason, quite simply, is that most of the people who will probably be living in China a generation from now are already alive.

Of the one and a quarter billion Chinese on the mainland today, roughly four-fifths will probably still be around in a quarter century. And that billion will account for the overwhelming majority of China's population in 2025. In fact, since the projected population won't be much larger than it is today, these survivors will constitute between two-thirds and three-fourths of China's total citizenry.

PROJECTING CHINA'S POPULATION TO 2025

In mid-1998, China's population (including Hong Kong, but not Taiwan) totaled 1.24 billion people. The United States Census Bureau estimates life expectancy at birth in China at just under 70 years.

China's fertility was no higher than the replacement level in the early 1990's. Indeed, the Census Bureau suggests that the fertility rate is currently about 1.8 births per woman per lifetime, about 15 percent lower than the 2.1 births necessary for long-term population stability. This means that China's fertility is about the same as that of Taiwan and South Korea – Asian countries whose birth rates have tumbled as they urbanized and grew rich.

What's more, the averages mask dramatic regional differences. Studies by demographers Judith Banister, Barbara Hammer and Loraine A. West indicate that the total fertility rate for urban Chinese may have been 1.3 or lower in a number of provinces by 1995 – lower than the current fertility in the European Union, known for its exceptionally low birth rate. In the great metropolises of Beijing and Shanghai, fertility rates may actually have fallen below 1.

NICHOLAS EBERSTADT is a visiting scholar at the American Enterprise Institute. He is the author of *The Tyranny of Numbers: Mismeasurement and Misrule* (AEI Press).

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Since China's population presumably will not be strongly affected by international migration, the rates of mortality and fertility will largely shape the country's demographic dimensions in 2025. The Census Bureau expects a gradual increase in Chinese life expectancy to about 75 years. The projection of fertility is more problematic.

The Census Bureau assumes that fertility will remain close to 1.8 births per woman per lifetime. But today's childbearing patterns exist under the shadow of the state's severe anti-natal population campaign. Would fertility rise if that program were discarded or reversed?

While China's population-control policies are clearly intended to limit reproduction, their current impact is unclear. Various bits of evidence support the conjecture that a revolution in attitudes about family size has swept China since Chairman Mao's death – and that this shift would prevent fertility from returning to traditional rates even if controls were lifted.

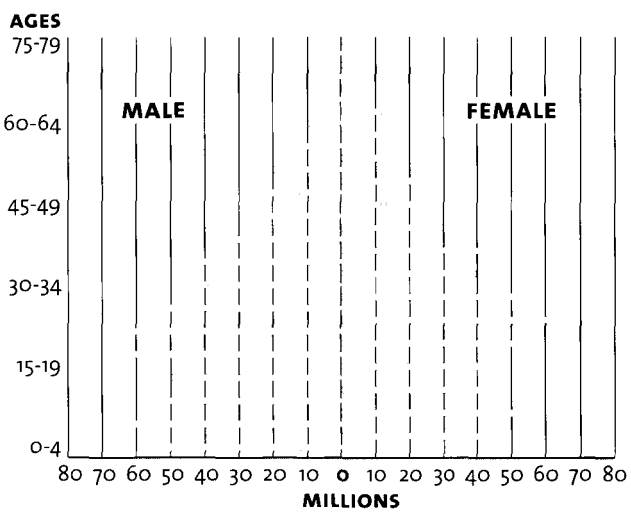
The United Nations' most recent "high variant" population scenario for China imagined only a modest increase in fertility from the current 1.8 up to 2.4 – not far above replacement. But even this scenario would not drastically alter our picture of China in 2025, raising the projected population by just 10 percent.

If demographic events unfold as expected, China's population (excluding Taiwan) will total just over 1.4 billion people in 2025. At that juncture, China may no longer even be the most populous country in the world: Recent U.S. Census Bureau projections place India's total population slightly higher a quarter century out.

If these projections prove correct, China's population will be approaching equilibrium in 2025, with a growth rate of just a tenth of 1 percent. That compares with the 1 percent pace of the 1990's and the rate of 1.5 percent of the late 1970's, when the One Child policy was unveiled. Between 1998 and 2025, under these projections, China's population growth will total just over 170 million.

That is an enormous number, but modest by modern China's experience. China's population rose by nearly 170 million in the 1960's alone. And in the 27 years between 1970 and 1997 (a span comparable to 1998-2025), the gain exceeded 400 million.

CHINA'S AGE PYRAMID, 1955



SOURCE: U.S. Census Bureau, International Programs Center Database

China's age structure in 2025 will look quite different than today's. While the total population is expected to grow by about 14 percent between now and the year 2025, this future China will have fewer children than the current one. Indeed, the number of Chinese under the age of 15 will be almost one-fourth smaller.

In all, the group 15 to 64 years of age – conventionally termed the working-age popula-

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tion – will be roughly 20 percent larger, but the changes within this group will be extremely uneven. While, for example, the number of people in their late 20's will drop by 30 percent, the cohort in their late 50's will expand by a staggering 150 percent. In fact, more people will be between the ages of 55 and 59 than in any other five-year age group.

The most explosive growth in China, however, will occur among the elderly, with the number over 65 likely to increase by 3.5 percent a year between now and 2025. China's age structure is thus about to shift radically from the "Christmas tree" shape so familiar among contemporary populations to something more like an inverted Christmas tree. Whereas in 1997 there were about 125 Chinese children under 5 for every 100 persons over 65, in 2025 China will have more than 250 elderly for every 100 youngsters. China will almost certainly be home to more grandparents than toddlers.

The Population exceeding 65 is likely to increase by 3.5 percent a year between now and 2025.

NON-PROBLEMS

What does this transformation augur? Start with the problems it will not create.

Like Beijing's leaders, foreign observers have been obsessed by the race between food and population in China. In an essay in 1995 in *Foreign Policy* titled "China's Coming Collapse," Jack A. Goldstone of the University of California at Davis warned that providing for an expected increase of 300 million to 400 million people in the next 20 years "is the largest problem facing China today," adding that this was "a development problem without parallel in recent history."

That same year Lester Brown, the president of the Worldwatch Institute, a Washington think tank had explained to readers of *The Washington Post* "How China Could Starve the World." By his account, burgeoning population would collide with faltering domestic agricultural capacity, creating havoc worldwide as China met an ever-greater share of its food needs with imports.

Malthusian worries, of course, are not new. But contemporary evidence suggests they are misplaced. China's population growth has thus far not compromised the agricultural potential of its land. Working with Chinese colleagues, Peter H. Lindert (also of the University of California at Davis) found no pattern of change in the country's soil quality in the past 60 years, even though China's population had almost tripled and grain production had probably more than tripled.

Perhaps the most careful assessment of China's prospective impact on world food markets was offered last year in a study for the International Food Policy Research Institute by Jikun Huang, Scott Rozelle and Mark W. Rosegrant.

In all likelihood, they suggested, China will continue to rely on world markets for only a small percentage of food needs. Chinese grain imports might double or even triple in the next two decades. However, it is by no means clear that the additional consumption will reverse the long-term decline in real grain

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ROBERT E. MUROWCHICK/PHOTO RESEARCHERS, INC.

Chinese poster extolling the virtues of having only one.

prices linked to rapidly rising agricultural productivity.

Nor does China face the personnel shortages that bedeviled Soviet military planners in the last years of the empire. By the 1980's the imperative of fielding an enormous army clashed with the manpower needs of the Soviet Union's planned economy. Complicating the problem, shifts in Soviet ethnic composition made Russians a minority within the pool of potential recruits.

By contrast, China's generals do not face these difficulties. Though China is a multiethnic empire, and ethnic Chinese have virtually the lowest fertility levels among the many nationalities within China's borders, Han Chinese men will still constitute nearly 90 percent of total candidates for military duty around 2025.

Nor will China be pinched for cannon fodder: In 2025 the country will still be home to 90 million men between 15 and 24.

LOOMING POPULATION PROBLEMS

What, then, are China's population problems likely to be? Three in particular deserve mention: rapid aging, declining civilian manpower and a shortage of brides.

Aging. Thanks to both rising life expectancy and extremely low fertility levels, China's population is about to age drastically. The aging, in fact, will proceed as swiftly as any in recorded history.

In 1995, the median age in China was 27 years – slightly lower than that of the United States in 1970. In the 20 years between 1970 and 1990, America's population aged by about four and a half years. By contrast, between 1995 and 2015 China's median age will jump by nine years. And by 2025, nearly half of China's population will be 40 or older.

Although Europe's affluent industrialized

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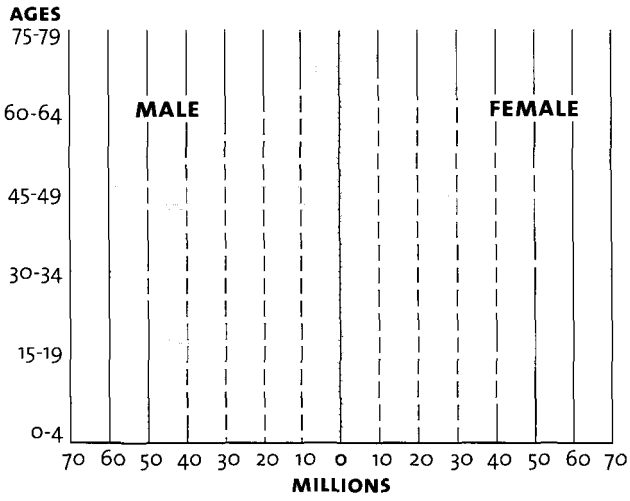
societies have had long life expectancies and small families for decades, none of them have witnessed the tempo of aging in store for China. Today Germany is Europe's most elderly nation, with a median age of 40, or roughly that of China in 2025. In the past 30 years, however, Germany's median age increased by just five years.

Perhaps the only parallel for the aging that awaits China is to be found in contemporary Japan, which has enjoyed exceptional longevity and experienced sub-replacement fertility for the past four decades. This graying of Japan has suddenly emerged as an issue of intense interest and concern to policymakers in Tokyo, who are now wondering just how their country should manage its growing public and private pension burden. Japan today, however, is vastly richer than China could hope to be by 2025.

CHINA'S AGE PYRAMID, 2025



SOURCE: U.S. Census Bureau, International Programs Center Database

Although estimates of per capita income remain problematic for China, World Bank calculations suggest that real output per head in China in 1995 stood at one-eighth the Japanese level and one-seventh the German level – eastern Germany included. Even if the brisk pace of material advance achieved in the past two decades continues unabated, China will still be the lowest-income country by far to cope with the sort of old-age burden it will face.

National income averages, furthermore, understate the magnitude of China's looming dependency problem. For despite its recent material progress, China remains a land of daunting economic disparities and crushing poverty. According to the World Bank's *World Development Report 1997*, China's income distribution is almost as skewed as the hard-case countries of Latin America, where inequality is generally viewed as a far more serious problem than in Asia. While the Bank numbers probably exaggerate inequality in China, they do suggest that China's lowest fifth was subsisting on barely a quarter of the country's none-too-high average income.

Other research from the World Bank indicates that 30 percent of Chinese suffered "absolute poverty" (defined by the Bank as living on less than $1 a day) in the period 1981-95 – twice the incidence for Indonesia and almost three times that for Pakistan. The proportion in poverty, of course, is lower today. Even so, it is very likely that in 2025 a substantial portion of Chinese will be poor by any standard. How will this impoverished group care for its elderly?

Today, the only real social safety net in China is the family: there are scarcely any public or private pension funds in the remote rural areas, where the bulk of China's poor reside. In the decades ahead, however, the

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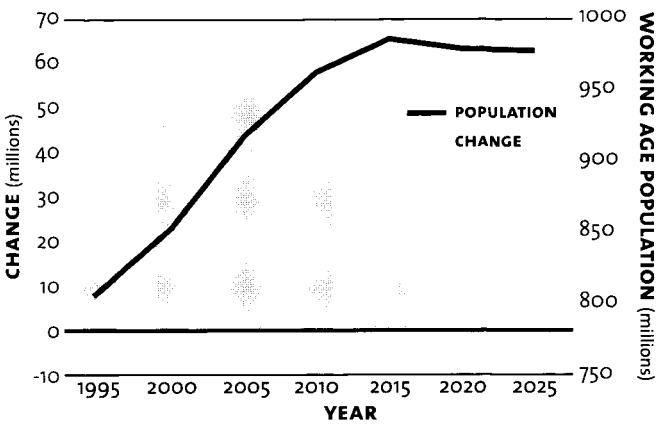
family will become an increasingly problematic mechanism for meeting the needs of elders.

The grandparents of 2025 will, by and large, be parents from the "One Child Norm" era who will have to contend with the delayed consequences of their own low fertility. Even if China's poorest grandparents in 2025 have had an average of more than two children (as now seems likely), a small but not insignificant fraction will have no surviving offspring. A much larger fraction – a fourth or more – will have no surviving sons. Thus they will find themselves in the unenviable position (at least in China) of depending on the largesse of their sons-in-laws – or even worse, competing for family resources against their sons-in-law's blood parents.

For now, China's patchwork pension system is of little help. Most plans are actuarially unsound and none offer generous coverage. Chinese policymakers have begun to grapple with comprehensive pension reform. But they have far to go and not much time to get there. Under the best of circumstances, meeting the old-age burdens of 2025 will be expensive and challenging.

Declining Manpower Availability. In the past generation, China's brisk growth in living standards was driven in part by an extraordinary increase in manpower. Indeed, between 1975 and 1995 about one-fifth of the increase in the gross domestic product can be attributed to the disproportionate growth of working-age Chinese.

ESTIMATED AND PROJECTED CHANGE IN CHINA'S WORKING AGE POPULATION, 1995-2025



SOURCE: U.S. Census Bureau, International Programs Center Database

This, however, is a once-only event. In 2025, the fraction of working-age people within the Chinese population will be about the same as today – 69 percent, according to the Census Bureau's projections. Indeed, the absolute size of the potential Chinese labor force in likely to peak in the next few decades and decline thereafter.

In the 1990's, China's working-age group was growing by just under 10 million people a year. In the first half of the next decade, it will grow by 12 million annually. Around 2015, however, the potential work force will peak at just under one billion. By 2025, in fact, China's working-age population is projected to be 10 million smaller than it will be in 2015. After 2025 this decline will accelerate, with the working-age group falling by about 70 million over 15 years.

Today, the only real social safety net in China is the family.

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Zero (or even negative) growth for a country's potential work force need not constrain labor productivity or impede development. In China's particular case, however, the manpower decline may complicate the quest for economic growth and enhanced productivity in two important ways.

For one thing, China's adult population has already been mobilized to a degree that Western countries have experienced only in wartime. According to the State Statistical Bureau in Beijing, nearly 700 million Chinese were employed in 1997 – 71 percent of all Chinese 15 years of age and older. Compare that number with Greece's reported 50 percent, Turkey's 53 percent and Russia's 60 percent (all in 1995). Even South Korea's labor force participation rate in 1995 was almost 10 percentage points lower than China's today.

Despite the government's longstanding emphasis on mass schooling, China remains a poorly educated nation.

China's employment numbers may conceal the underemployment common in predominantly rural societies. But it is still hard to argue that China will be able to harness huge reserves of manpower in the years ahead. In fact, regression to rates of labor-force participation normal in other countries could eliminate the entire expected increase in working-age population in the next decade and a half.

Second, improvements in labor productivity will depend upon training. And despite the Government's longstanding emphasis on mass schooling, China remains a poorly educated nation. Estimates by Robert Barro of Harvard University and Jong-hwa Lee of Korea University suggest that average educational attainment for the population 15 years and older in China was under six years in 1990. That is a year more than the comparable figures for India and Indonesia. But it is a year less than in the Philippines (whose per capita output is roughly equal to China's) and four years less than in South Korea.

Younger people in China are generally better educated than their elders. But China's demographic trends will slow the pace at which educational attainment percolates through the working-age population. In the late 1970's, the cohort of 10- to 14-year-olds was over a fifth the size of the country's entire working-age population. Today that cohort is less than a seventh the size of China's working-age group, and it will be only a twelfth as large in 2015. Other things equal, this presages a slowdown in the pace of education-based improvements in productivity.

The challenges posed by declining manpower are surmountable. A more flexible labor market would permit today's workers to transfer to higher productivity employment. The education system could upgrade the skills of the adult population along with the young. Such changes, however, would require political will, and would generate risks as well as opportunities for hundreds of millions of Chinese displaced from the jobs they knew.

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The Bride Shortage. China will not, of course, be the first country to experience rapid aging or a shrinking of its potential work force. One impending demographic trend for China, however, looks unprecedented in scale and scope: the imbalance between men and women of marriageable age.

The sex ratio for babies has exhibited a strong biological predictability worldwide, with 105 to 107 boys for every 100 girls. After the advent of China's "One Child Norm," however, the reported Chinese sex ratio at birth began a steady, eerie, rise. In 1995, a Chinese national sample census counted 118 boys under age 5 for every 100 girls.

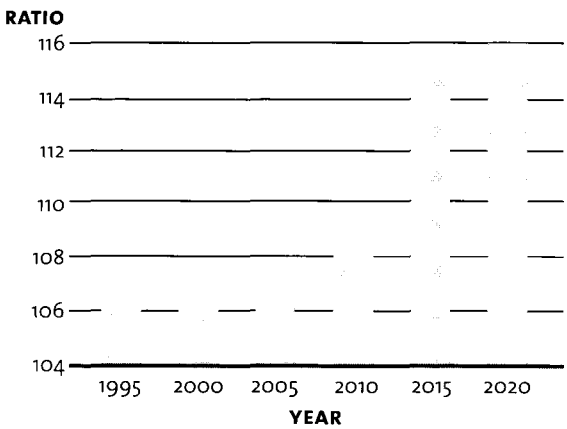
In part this imbalance was probably a statistical artifact: Faced with state-enforced birth quotas, some parents hid their daughters so that they might try again for a boy. However, most of the reported imbalance appears to be real, the consequence of sex-selective abortion and, to a much lesser extent, female infanticide.

Today's striking imbalance among infants means there will be a corresponding mismatch between prospective husbands and brides two decades hence. The dimensions of this mismatch are illustrated in the chart to the right, which shows the Census Bureau's projections for the sex ratio for Chinese in their early 20's. Between 1995 and 2020, the number of young Chinese men for every 100 young Chinese women is expected to increase from 105 to 116. A slight decline – to 114 – is projected for the following five years. But that decline is simply an assumption: The girls and boys in question have not yet been born.

By tradition, virtually all Chinese men and women able to marry ultimately do marry. In theory, the impending bride shortage could be finessed if men married outside their cohorts – specifically, by marrying younger women. Indeed, in China's past this was the solution to the more modest problem of "excess" males, since each new cohort was larger than the one before it. In the coming decades, by contrast, low fertility will mean that each birth cohort is smaller than the one before it.

ESTIMATED AND PROJECTED SEX RATIOS, 20 TO 24 AGE GROUP, 1995-2020

(men per 100 women of same age group)



SOURCE: U.S Census Bureau, International Programs Center, specially requested projection March 1998.

Thus, to the degree that China's young men in the coming century solve their mating problem by marrying younger women they will intensify the marriage crisis for younger men. Searching abroad for Chinese wives will be a dead end: By 2020 the surplus of China's males in their 20's will likely exceed the entire female population of the island of Taiwan. So unless China accommodates a radical change in cultural attitudes toward marriage, the stage will be set for an increasingly intense competition for brides.

What forms will this competition take, and

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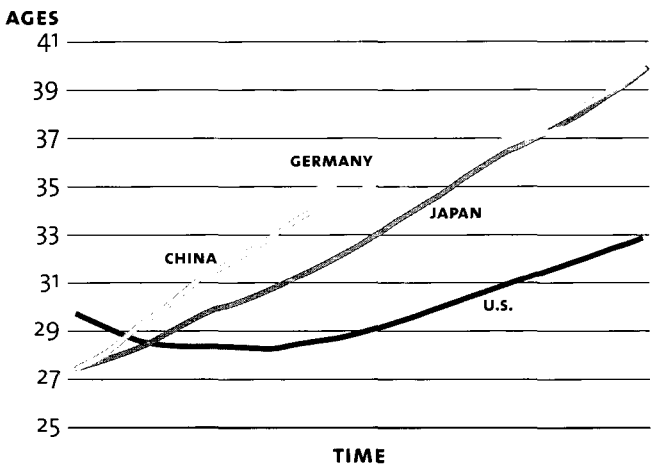
how will Chinese society be affected? A 1997 essay in the journal *Renmin Luntan* direly predicted "such sexual crimes as forced marriages, girls stolen for wives, bigamy, visiting prostitutes, rape, adultery" as well as homosexuality "and weird sexual habits."

The assessment seems overwrought. Yet even if one dismisses the posited social degeneration, the coming bride shortage in China is likely to create extraordinary tensions. And a significant fraction of China's young men will have to make do without marriage and children.

Not a few of them will be struck by the bitter irony of their circumstance. At a time that China's wealth and power will be greater than ever before, their prospects for social fulfillment are dwindling. How they cope remains to be seen – and may bear directly on the character and behavior of the China that awaits us.

CHINA'S AGING PROCESS IN INTERNATIONAL PERSPECTIVE:

Projected Median Age for China in Comparison With Past Experience in Selected Countries



SOURCE: U.S. Census Bureau, International Programs Center Database

Maoist political economy, not the population surge, was the primary productivity killer.

In using coercion to slow population growth, China's leadership was guided by a simplistic Malthusian vision of the country's prospects. Cutting growth, in this view, would directly ease the race between food and mouths, and stimulate material advance.

If they had been right, the end might, arguably, have justified the means; however, they badly misdiagnosed the dynamic at play. Maoist political economy, not the population surge, was the primary productivity killer. Indeed, what economists call total factor productivity may actually have been falling in China – that ever greater amounts of capital and natural resources as well as labor were needed to produce a constant amount of output during the Great Leap Forward.

Only in China have leaders demanded such broad and immediate sacrifices in the hope of such distant and debatable benefits. In the final analysis, their hubris may be the most striking feature of modern China's demographic predicament.

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Luxury Fever

Why Money Fails to Satisfy in an Era of Excess

ILLUSTRATIONS BY
JIM TSINGANOS

Spending more and enjoying it less? The ironic joys of consumerism have long been fodder for bumper-sticker philosophers – as in "He who dies with the most toys wins." But serious economists seem stuck with the idea that more stuff makes people happier. ¶ Correction: most serious economists. Bob Frank of Cornell University earned his spurs as the thinking man's liberal, first as an architect of airline deregulation in the 1970's and later as an investigator of the no-man's land between psychology and economics. His 1995 book, *The Winner-Take-All Society* (written with Philip Cook of Duke), illuminated a trend toward income inequality in professions ranging from law to basketball. ¶ Now, in the tradition of Thorstein Veblen, Frank is challenging the logic of the consumerist rat race. Consumption, he argues, generates external costs to society the way industry production generates environmental pollution. And the solution is to "internalize" these costs with radical tax reform. ¶ Sound like a stretch? Read this excerpt from *Luxury Fever* (© Free Press, 1999), and decide for yourself.

BY ROBERT FRANK

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The propane grill I bought during the 1980's has been on a downhill slide for several years. First to go was its ignition button, the crude mechanical spark generator that normally fires up the gas. Lighting the grill is now a delicate operation. I turn on the gas, wait a few seconds and then throw a match inside. Throw it in too soon, and it goes out before it reaches the burner below. Wait too long, however, and it sets off a small explosion. A second problem is that the metal baffle atop the burners has rusted through in the middle. This concentrates an enormous amount of heat over a small area near the center of the cooking surface, but very little elsewhere. I am still able to cook reasonably good chicken and small steaks if I quickly rotate pieces in and out of the hot zone. But grilling a big fish fillet has become impossible.

My grill's various deficiencies could surely be repaired, but I have no idea by whom. And even if I did, the cost would almost surely exceed the $89.95 I originally paid for it. And so, reluctantly, I find myself in the market for a new one.

If you have searched this market yourself recently, you know that the menu of available choices is profoundly different from what it was 10 years ago. I vaguely remember models available then with built-in storage cabinets and shelf extensions on either side. But even with these embellishments, the most you could spend was a few hundred dollars. There was nothing – absolutely nothing – like today's Viking-Frontgate Professional Grill.

Powered by either natural gas or propane, it comes with an infrared rotisserie that can slowly broil two 20-pound turkeys to perfection while you cook hamburgers for 40 guests on its 828-square-inch grilling surface. It has a built-in smoker system that "utilizes its own 5,000-B.T.U. burner and watertight wood chip drawer to season food with rich woodsy flavor." Next to its grilling surface sit two ancillary range-top burners. Unlike the standard burners on your kitchen stove, which generate 7,500 B.T.U.'s, these burners generate 15,000 B.T.U.'s, a capability that is useful primarily for the flash-stir-frying of some ethnic cuisines and for bringing large cauldrons of water more quickly to a boil. If you have ever longed to throw together a Szechwan pork dish on your backyard patio or feared getting off to a late start when you have guests about to arrive and 40 ears of corn left to cook, the Viking-Frontgate has the extra power you may need. The entire unit is constructed of gleaming stainless steel with enamel and brass accents, and with its fold-out workspaces fully extended, it measures more than seven feet across.

The catalogue price of the Viking-Frontgate Professional Grill, not including shipping and handling, is $5,000. If that's more than you want to pay, many cheaper models are available. For instance, the all-stainless Weber-Stephens Summit Grill, which the company touts in four-page spreads in *Forbes* and *Vanity Fair* and which has almost as many bells and whistles as the Viking-Frontgate, sells for only $3,000. And

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for shoppers who feel they can get by with an 18 by 24 inch grilling surface and only one ancillary range-top burner, Frontgate offers a model for $1,140 that delivers "professional results at a great value."

Even Frontgate's stripped-down model, however, sells for considerably more than most of us would have dreamed possible a mere decade ago. And indeed, most of the 12 million charcoal and gas grills sold annually

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in the United States still cost less than $700, a category that will surely include my own next grill as well. Yet grills costing more than $2,000 are by no means rare in the current market. On the contrary, they have become by far the fastest-growing sector in the $1.2 billion-a-year industry.

The evolution of spending patterns in the gas-grill industry is part of a much broader change that has been occurring in recent decades. Popular impressions of what has been happening may be misleading since only the most spectacular examples tend to capture media attention. In one typical recent piece, for instance, *The New York Times* interviewed Alan Wilzig, 32, a Jersey City banker, about the lavish, medieval-style castle he and his brother had just built in the Hamptons.

> Q: This place cost you nearly $10 million to build. Why build something so opulent?
>
> A: To build. It's like having the biggest erector set in the world. It takes about the same amount of effort to buy a $200 million bank as it does to buy a $20 billion bank. Same with a house. You might as well buy the biggest one that you can handle responsibly. We built 14,000 square feet in 14 months. What would have been different if we had built an 8,000-square-foot house with half as many fun things to do?
>
> Q: You have an underwater sound system in your swimming pool, indoor and outdoor hot tubs, a tennis court, 80 gilt mirrors and six suits of armor. If you could add one toy or feature to the castle, what would it be?
>
> A: [pauses] Nothing. If we would have thought of it, we would have built it.

The spending habits of people like the Wilzigs, so remote from what most of us experience, may seem to have little relevance for our own lives. And indeed, the spending of the superrich, though sharply higher than in decades past, still constitutes just a small fraction of total spending. Yet their purchases are far more significant than might appear, for they have been the leading edge of pervasive changes in the spending patterns of middle- and even low-income families. The runaway spending at the top has been a virus, one that has spawned a luxury fever that, to one degree or another, has all of us in its grip.

Thus, although it is the mansions of the superrich that make the news, the far more newsworthy fact is that the average house built in the United States today is nearly twice as large as its counterpart from the 1950's. And although it is the $250,000 sticker price of the 12-cylinder Lamborghini Diablo that prompts the finger-wagging of social critics, the more telling observation is that the average price of an automobile sold in the United States now exceeds $22,000, up more than 75 percent from just a decade earlier.

No matter where you stand on the income scale, no matter how little you feel you are influenced by what others do, you cannot have escaped the effects of recent changes in the spending environment. Among other things, they affect the kinds of gifts you must give at weddings and birthdays, the amounts you must spend for anniversary dinners, the price you must pay for a house in a neighborhood with a good school, the size your vehicle must be if you want your family to be relatively safe from injury, the kinds of sneakers your children will demand, the universities they'll need to attend if you want them to face good prospects after graduation, the kinds of wine you'll want to serve to mark special occasions and the kind of suit you'll choose to wear to a job interview.

At one level, the recent upgrades in what we

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buy might seem a benign symptom of the fact that we are more productive, and hence richer, than ever before. Our cars are not only faster and more luxuriously appointed, but also safer and more reliable. And although social critics may lampoon the frills of modern appliances, which of these critics would trade their current appliances for the ones they owned 20 years ago? Although we seem to concede that money does not always buy happiness, most of us remain steadfast in our belief that having more of it would be a good thing.

But there is also a dark side to our current spending patterns. Whereas those at the top of the economic totem pole have done spectacularly well, the median American family has gained virtually no ground at all during the past two decades, and those in the bottom fifth have actually suffered earnings losses of more than 10 percent in real terms. Similar changes have occurred in Britain, and this pattern has begun spreading. With static or declining incomes, middle- and low-income families have thus had to finance their higher spending through lower savings and sharply rising debt. In the process, our personal savings rate has fallen steadily and is now significantly lower than that of any other major industrial nation. Personal bankruptcy filings are at an all-time high.

Even among those who can easily afford today's luxury offerings, there has been a price to pay. All of us – rich and poor alike, but especially the rich – are spending more time at the office and taking shorter vacations; we are spending less time with our families and friends; and we have less time for sleep, exercise, travel, reading and other activities that help maintain body and soul. Because of the decline in our savings rate, our economic growth rate has slowed, and a rising number of families feel apprehensive about their ability to maintain their living standards during retirement. At a time when our spending on luxury goods is growing four times as fast as overall spending, our highways, bridges, water supply systems and other parts of our public infrastructure are deteriorating, placing lives in danger. Our parks and streets are becoming dirtier and more congested. Poverty and drug abuse are on the rise, and violent crime, though down from its recent historical peaks in some cities, continues at high levels. A growing percentage of middle- and upper-income families seek refuge behind the walls of gated residential communities.

Although we seem to concede that money does not always buy happiness, most of us remain steadfast in our belief that more of it would be a good thing.

We have long grown accustomed to hearing social critics carp about how much better society as a whole would be if we could manage to spend our money a little differently. And indeed, common sense seems to confirm that at least some of the spending by the superrich could be put to better uses. The barstools aboard the late Aristotle Onassis's

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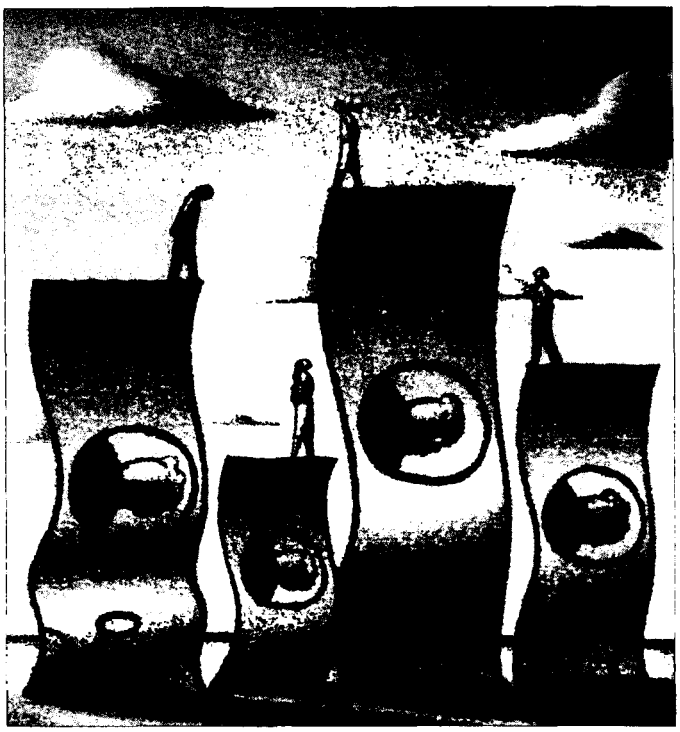

yacht, the Christina, were covered with the buttery soft – and jarringly expensive – foreskin of the sperm whale penis. The vessel's faucets were of solid gold and at the flip of a switch its swimming pool could be covered by a retractable, mosaic-tiled dance floor.

The Christina was just one salvo in Onassis's costly battle to outdo his rival shipping magnate, Stavros Niarchos, whose own yacht, the 375-foot Atlantis, was designed by an architect whose explicit instructions were to make it 50 feet longer than the Onassis vessel. Can anyone doubt that it would have been better to build each boat a little smaller and use the money thus saved to provide school lunches for hungry children?

Yet only the lunatic fringe would empower our government to confiscate money from anyone bureaucrats may feel is spending it unwisely. As conservatives are correct to remind us, the very incentives that led people like Onassis and Niarchos to accumulate such vast wealth have also resulted in millions of new jobs and dramatically improved levels of overall prosperity. If our high and rising living standard rests on the continued willingness of the rich to work hard and take risks, what does it really matter if they sometimes spend their money in frivolous ways?

Telling points all, and ones that critics of our current spending patterns have failed to address. To say that the world we live in isn't perfect is simply not an interesting claim. The real question is whether there is any practical way to make things better.

My central premise is that the answer to this question is unequivocally yes. There are not only alternative ways of spending our time and money that we would strongly prefer, but also simple and practical ways to get there.

A host of careful studies suggest that across-the-board increases in our stocks of material goods produce virtually no measurable gains in our well-being. Bigger houses and faster cars, it seems, don't make us any happier. But other studies identify a variety of categories in which extra spending would promote longer, healthier and happier lives for all. For example, we could expect such improvements if we spent more to alleviate traffic congestion or spent more time with our families and friends or provided cleaner air and drinking water for our cities.

The more novel and provocative element of

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my claim is that we can actually achieve such changes without having to compromise other important values. We will not need to empower bureaucratic commissions to make judgments about which specific forms of consumption are wasteful. Nor will we need to engage in painful acts of self-denial. Nor will we need to risk crippling the incentives that lead talented and industrious people to create new wealth. Rather, I will suggest a simple revision of our existing spending incentives that will make it possible for each of us to pursue our respective vision of the good life more fully and effectively, no matter what (within reason) those visions might be.

On its face, this may seem a preposterous claim. If better living conditions were so easily achieved, why haven't we already achieved them? If we would be happier working shorter hours and spending more time with our families, even though that would mean living in smaller houses and buying less expensive cars, why don't we just do it?

Over the past several years, the so-called voluntary simplicity movement has spawned dozens of popular self-help books that urge us to scale back, telling us we will be happier if we adopt simpler, less harried lifestyles. The brisk sales of these books suggest that their authors have struck a resonant chord. Their upbeat message is that more comfortable, stress-free living patterns are ours for the taking. All we need do is control our appetites.

Skeptics can be forgiven, however, if they find this a naïvely optimistic view. If we would really be happier with simpler lifestyles, it seems a safe bet that we wouldn't need self-help manuals to discover this. It would have been part of our shared cultural wisdom all along.

The fact that we are working more hours and buying more goods than ever before has led champions of the status quo to conclude that our current spending patterns, for all their apparent shortcomings, must reveal what we truly value most. Sure, it would be nice to have both bigger houses and more time for our families; but when forced to choose, we seem to opt overwhelmingly for the former. This is a powerful rejoinder, and social reformers are destined to continue losing their debates with defenders of the status quo until they can come up with a persuasive response to it.

Yet the plain truth, as even the most ardent free-marketeers have known all along, is that the choices of rational, well-informed people do not always add up to a whole that meets their approval. One of the clearest examples involves activities that pollute. The fact that millions of motorists voluntarily drive to work in Los Angeles does not mean that they approve of the resulting smog that enshrouds their city. On the contrary, smog tends to be excessive in many cities because any individual who endured the inconvenience of car pooling or riding the bus would end up breathing essentially the same dirty air as if he drove. Making these sacrifices might be worth it if everyone else also made them, for then we would get significantly cleaner air. But individuals can control only their own choices, not the choices of others.

The incentives we confront as individual consumers are often problematic in precisely analogous ways. As a 17-year-old Detroit high-school senior, Terrell Garner saved his earnings from a part-time job for several months to be able to buy an $875 pair of alligator shoes to wear to his senior prom. Many social critics would object that he did so because he was duped by sophisticated marketing tactics. Yet so brisk is the demand for these shoes that the Detroit retailers who sell

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them see no reason to bother advertising. Garner's choice is more plausibly understood if we assume that he perceived correctly that these shoes would create just the impact he wanted: "Once I stepped in the door [at the prom], it was like 'Pow!'" he said, describing the "shoes' mythical, almost explosive appeal."

This appeal would not exist except for the fact that his shoes stood out relative to the shoes worn by others. Garner had no reason to feel concerned that the combined effect of his and others' purchase decisions made it considerably more expensive for someone to stand out from the crowd. But as he moves on to higher paying jobs, he will discover that the cost of achieving similar impact from a new pair of shoes will rise accordingly. A Detroit attorney, Thomas Marshall, for example, now owns 10 pairs of alligator shoes, including a pair that cost him $3,000; and Cecil Fielder, the baseball player, reportedly owns several hundred pairs in 26 different colors.

The irony is that if, within each social group, everyone were to spend a little less on shoes, the people who stand out from the crowd now would continue to do so. And because that outcome would free resources to spend in other ways, people would have good reasons to prefer it. Each individual, however, can choose only the amount that he spends on shoes, not the amounts spent by others. Similarly, Onassis and Niarchos might not have minded if both their yachts had been a little shorter; but each could choose only his own yacht's length, not the other's.

Adam Smith's celebrated invisible hand – the claim that society as a whole does best when individuals pursue their own interests in the open marketplace – rests on the assumption that each person's choices have no negative consequences for others. Yet even the most ordinary spending choices frequently do have negative consequences for others, just as the presence of a preschooler with the chicken-pox has negative consequences for others. If I buy a 6,000-pound sport utility vehicle, I increase the likelihood of others dying in a traffic accident; and in the process, I create an incentive for them to buy heavier vehicles than they otherwise would have chosen. If I buy a custom-tailored suit for my job interview, I reduce the likelihood that others will land the same job; and in the process, I create an incentive for them to spend more than they had planned on their own interview suits. When I stay an extra hour at the office each day, I increase my chances for promotion; but in the process, I reduce the promotion prospects of others and thereby create an incentive for them to work longer hours than they otherwise would have chosen. In situations like these, individual spending decisions are the seeds of a contagious process.

Situations like these are by no means exceptional. H.L. Mencken once defined a wealthy man as one who earns $100 a year more than his wife's sister's husband, and considerable evidence confirms the wisdom of his observation. People who earn $40,000 a year may be happy or sad, but they are far more likely to be satisfied with their material standard of living if their associates earn $35,000 rather than $60,000.

As a young man fresh out of college, I served as a Peace Corps volunteer in rural Nepal. My one-room house had no electricity, no heat, no indoor toilet, no running water. The local diet offered little variety and virtually no meat. Yet, although my living conditions in Nepal were a bit startling at first, the most salient feature of my experience was how quickly they came to seem normal. Within a matter of weeks, I lost all sense of

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impoverishment. Indeed, my $40 monthly stipend was more than most others had in my village, and with it I experienced a feeling of prosperity that I have recaptured only in recent years.

But even though I felt completely satisfied with my living conditions there, I would experience a crushing sense of poverty if I were to live in the United States or any other prosperous country under those same conditions. Not a day would pass in which I would not be keenly aware of the extent to which my circumstances fell short of community standards. Things I did not feel I needed in Nepal I would feel I needed here.

The poor are not the only ones who experience pressure to spend more when community consumption standards rise. It is natural for people at all income levels to experience new desires in the presence of others who spend more than they do. And even apart from any changes in what we consciously desire, our individual spending decisions are often influenced by the fact that our menu of available choices is so strongly shaped by what others spend.

The real significance of offerings like the $5,000 Viking-Frontgate Professional Grill is that their presence makes buying a $1,000 unit seem almost frugal. As more people buy these up-market grills, the frame of reference that defines what the rest of us consider an acceptable outdoor grill will inevitably continue to shift. I could easily spend $1,000 on a new grill tomorrow, and few people would notice that I had done anything strange. More troubling still is the possibility that, with ready opportunities to spend five times that amount and more, I might fail to notice anything strange about spending $1,000 to replace my $90 gas grill.

In short, both the things we feel we need and the things available for us to buy depend largely – beyond some point, almost entirely – on the things that others choose to buy. When people at the top spend more, others just below them will inevitably spend more also, and so on all the way down the economic ladder. As this happens, simpler versions of products that once served perfectly well often fall by the wayside.

Both the things we feel we need and the things available for us to buy depend largely – beyond some points, entirely – on the things that others choose to buy.

This diagnosis of why our current spending patterns are problematic suggests the possibility, at least in principle, of reducing the speed of the consumption treadmill, thereby freeing resources that can be put to various uses that would make more of a difference in our lives. My case for change rests not at all on the social critic's claim that luxury consumption is self-indulgent or decadent, but rather on detailed and persuasive scientific evidence that if we adopt a simple change in the incentives we face, all of us can expect to live longer, healthier and more satisfying lives.

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Yet it would be a mistake not to acknowledge that the case for changing our current consumption patterns entails a moral dimension as well. In our rush to balance federal, state and local government budgets, we have slashed funding not only for bridge and highway maintenance but also for hospitals that serve the poor, the Head Start program, the

school lunch program, drug rehabilitation programs, homeless shelters and a host of other low-overhead programs that make life more bearable for our neediest citizens. These programs are being cut not because they do not work, not because they destroy incentives, but because we say we cannot afford them.

The average taxpayer's annual contribution to Head Start and other programs for needy citizens is small – far less than many upper-middle-class couples spend on wine for a single dinner party. As by far the richest country in human history, we should be doing more, not less, to provide better opportunities for others less fortunate. And as we shall see, the only cost required to take these steps is a small and temporary across-the-board reduction in the rate of growth of material goods consumption by middle- and upper-income families. In the face of this truly negligible cost, our current policies become all the more difficult to defend.

Again, however, my aim is not to scold but to describe a striking new set of possibilities. In the fact that our current consumption patterns entail a substantial measure of waste lies the seeds of a golden opportunity. By a simple and easily achieved rearrangement of our current consumption incentives, we can effectively enrich ourselves by literally trillions of dollars a year. Seldom in our history have moral imperatives and naked self-interest been so closely aligned.

DOES MONEY BUY HAPPINESS?

Many regard it as self-evident that we would have done better to have spent our money differently. Yet the mere fact that there are useful things we could have bought does not, by itself, imply that we have chosen poorly. An alternative interpretation – one strongly favored by defenders of the status quo – is that the pleasures of additional material goods are more than enough to compensate for the sacrifices the goods make necessary in other areas. Life is full of trade-offs, these defenders say, and the people whose own money is at stake are in the best possible position to resolve them.

If the defenders of the status quo are correct, we should expect to find some indications that further accumulations of material goods continue to provide significant increments in satisfaction, even after countries achieve levels of affluence like those currently enjoyed in the United States. But the scientific literature provides no support for this position. Once a threshold level of affluence is reached, the average level of human well-

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being in a country is almost completely independent of its stock of material goods.

The sources of human satisfaction have been a subject of discussion and debate through the ages. Does happiness spring from wealth and power, romantic love and steadily improving golf scores? Or do the sources of true and lasting happiness lie, as many insist, beyond the self in helping others or in religious devotion?

Philosophers have even questioned whether happiness, in and of itself, is an important human goal. Robert Nozick asks us to imagine an opportunity to hook up to an "experience machine" capable of simulating any experience we might desire. This machine could "make you think and feel that you were writing a great novel, making a friend or reading an interesting book. All the time you would be floating in a tank, with electrodes attached to your brain." You could choose from a huge library of the experiences that have been found satisfying by people from all walks of life. You would even be free to program in intervals during which the machine would shut down, allowing you to reconsider and adjust your mix of experiences.

While the machine is in action, however, the experiences it delivers will constitute perfect virtual reality. Subjectively, you will experience them exactly as if they were actually happening. Given this opportunity, Nozick's question is, should you plug in?

He concedes the powerful attractions of doing so. Yet no matter how pleasurable the experiences you might imagine, he argues, there are even more compelling reasons for refusing the offer: "We want to be a certain way, to be a certain sort of person." Someone floating in a tank is an indeterminate blob. There is no answer to the question of what a person is like who has long been in the tank. Is he courageous, kind, intelligent, witty, loving? It's not merely that it's difficult to tell; there's no way he is. Plugging into the machine is "a kind of suicide."

Nozick's vivid thought experiment drives home the point that feeling happy is hardly the only important goal in life. Given the multitude of competing conceptions of the good life, perhaps the most we can hope for in our social institutions is that they grant the widest possible latitude to forge lives that suit us.

How are we to evaluate the extent to which an economy succeeds at this task? In the context of modern democracies in which fundamental political liberties have been assured, the approach most often taken by economists is simply to measure the aggregate value of the economy's goods and services. The presumption is that the economy that serves up the largest per-capita national income is the one that best serves the interests of its citizens.

Critics lambaste national income as a measure of human welfare, noting that it ignores the value of work performed within the family. For instance, if a man marries his accountant, national income goes down even though the amount of accounting services she performs remains the same. Critics also complain that national income rises when sophisticated advertising campaigns manipulate us to buy goods and services we don't really need.

Does that mean we would be better off if we entrusted government with the decision of what goods to produce? The unhappy experience of collectively managed economies provides little support for that alternative.

If happiness could actually be measured, most economists would predict that people in rich countries would be happier, on the average, than people in poor countries and that,

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in an environment in which incomes are rising over time, people should be happier today, on the average, than they were in earlier times.

Unlike economists, psychologists and other behavioral scientists have few preconceptions about the extent to which free-market transactions promote human satisfaction. Whereas economists simply assume that money buys satisfaction (because having more of it broadens one's options), psychologists try to measure individual differences in satisfaction and then investigate how these differences are related to differences in income and other factors.

It seems that what the psychologists call subjective well-being is a real phenomenon.

If other things are equal, people who experience a greater balance of positive emotions over negative emotions will tend to experience higher levels of subjective well-being. Yet the relationship between the balance of emotions that someone experiences and her overall level of subjective well-being is by no means simple.

Although it might seem natural to think that a person must be either in a good mood or in a bad mood at any moment in time, in fact it is possible for people to experience both strong positive and strong negative emotions simultaneously. Indeed, neuroscientists now recognize that positive and negative feelings are governed by two largely independent sets of neural circuitry and that emotions in the two classes are not strongly correlated with one another.

The stereotypically happy person is someone who experiences frequent and intense levels of positive affect and infrequent and mild levels of negative affect. By contrast, the stereotypically unhappy person is someone for whom frequent and intense levels of negative affect are coupled with infrequent and mild levels of positive affect. People who experience high levels of both positive and negative affect are often described as volatile or highly emotional, while those with low levels on both scales are called phlegmatic.

Psychologists measure life satisfaction in various ways. By far the most popular approach has been simply to ask people how happy or satisfied they are. For example, people may be asked to respond, on a numerical scale, to a question like, "All things considered, how satisfied are you with your life as a whole these days?" Or, "Thinking of your life as a whole, would you consider yourself (a) very happy; (b) fairly happy; or (c) not happy."

More recently, neuroscientists have also used brain-wave data to assess positive and negative affect. Subjects with relatively greater electrical activity in the left prefrontal region of the brain are likely to indicate strong agreement with statements like the previous ones, while those with relatively greater electrical activity in the right prefrontal region are much more likely to disagree with these statements. The left prefrontal region of the brain is rich in receptors for the neurotransmitter dopamine, higher concentrations of which have been independently shown to be correlated with positive affect.

Observed consistency is, if anything, even more powerful for the brain-wave measures. In a sample consisting mostly of American

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college students, the neuropsychologist Richard Davidson found that people who registered high positive affect on one occasion (as measured by a high level of electrical activity in the left prefrontal regions of their brains) tended to register similarly high levels one month later. Davidson observed similar stability among subjects showing high levels of negative affect. (Davidson notes with interest that, on both occasions, the brain waves of one particular individual in his sample, a Tibetan monk who was in the United States for a brief visit registered dramatically higher positive affect levels than any other subject.)

Ratings derived from interviews with mental-health professionals are highly correlated with self-reported subjective well-being. People who describe themselves as happy are able to recall more positive events from recent experience, and fewer negative events. And the various measures of subjective well-being also respond to good and bad life experiences, and to therapy, in the expected ways. Someone who has experienced the recent death of a loved one, for example, is likely to exhibit sharply reduced subjective well-being, irrespective of the measure chosen.

In short, it seems that what the psychologists call subjective well-being is a real phenomenon. The various empirical measures of it have high consistency, reliability and validity.

Turn now to an assessment of the relationship between subjective well-being and income. Throughout the industrialized world, average incomes have been growing sharply for the past several hundred years, and the amount and quality of the goods and services we consume have increased accordingly. Are we significantly happier on that account?

One of the central findings in the large scientific literature on subjective well-being is that once income levels surpass a minimal absolute threshold, average satisfaction levels within a given country tend to be highly stable over time, even in the face of significant economic growth. For example, although per capita income was 39 percent higher in real terms in 1991 than in 1972 in the United States, the proportion of people who considered themselves very happy actually declined slightly over the period.

Of course, other factors affect satisfaction levels besides income and the material goods it commands. Perhaps a large income effect on happiness during the period shown was offset by some other negative effects. Yet average satisfaction levels are also found to be unresponsive to changes in average income levels in other countries and during other time periods.

The average satisfaction level reported by survey respondents in Japan remained essentially unchanged between 1958 and 1986, a particularly striking finding in view of the fact that per-capita income rose more than five-fold during that period. In automobile and appliance ownership, Japan in the late 1950's was essentially no different from many developing countries today.

Yet the data do not allow us to conclude that people are equally satisfied no matter how poor they might be. On the contrary, most careful studies find a clear relationship over time between subjective well-being and absolute income at extremely low levels of absolute income. Thus, in a country in which most people lack minimally adequate shelter and nutrition, across-the-board increases in income appear, not surprisingly, to yield significant and lasting improvements in subjective well-being. In the same vein, average satisfaction levels are significantly lower in extremely poor countries than in rich ones.

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Our concern here is with how differences in consumption affect citizens' well-being in countries that have already achieved a measure of affluence. And for such countries, average satisfaction levels are not significantly correlated over time with income.

EXCELLENT, RELATIVELY SPEAKING

If in fact we could all live better lives by simply changing our spending patterns, why haven't we done that? Many people are aware that we might be better off if all saved more and all spent less on houses and cars. But that choice is simply not an item on any individual's menu. A family can choose the amount it spends on its own house, but it cannot choose the amounts that others spend.

In this observation lies a key to understanding why the things we buy are so often not the things that best promote our own interests. The orthodox models that underlie Adam Smith's invisible hand take the primary economic determinant of a person's sense of well-being to be his absolute standard of living. But as virtually everyone has long been aware, it is relative living standards that often prove more important. And as we shall see, when satisfaction depends on relative living standards, all bets regarding the efficacy of the invisible hand are off.

Having been raised as an only child, I have always observed the sibling rivalries among my own children with great interest. On returning from a friend's house, my 8-year-old son immediately asks "Where's Chris?" if his 11-year-old brother is nowhere in sight. When Chris is at his violin lesson or at the orthodontist's office, we have no problem. But let him be at a movie, and the next thing we'll hear is Hayden's angry shout of "That's not fair!" – the inevitable prelude to an anguished outburst about the injustice of life.

As children grow older, their complaints become more muted, but their concerns about unequal outcomes never truly disappear. And even if we could, would we really want to stifle these concerns completely? Despite all the pain and suffering that spring from unequal outcomes, real or imagined, it is hard to see how someone stripped of these concerns could function effectively in the world as we know it. A child who didn't care how her own serving of ice cream compared with her brother's would be unlikely to achieve the station in life that her talents and abilities might otherwise command.

Study after careful study shows that, beyond some point, the average happiness level within a country is almost completely unaffected by increases in its average income level. Thus, average satisfaction levels register virtually no change even when average incomes grow manyfold.

But both in what we say and what we do, we give every indication that our incomes are a matter of enormous concern. When psychologists ask what change in our circumstances would most improve the quality of our lives, our most frequent response is "more money." And indeed, if this were not so, why would first-year associates work 80-hour weeks in New York law companies? Why would oilfield firemen risk their lives and health? Why would the Tobacco Institute's expert witnesses humiliate themselves by making preposterous claims on the witness stand? The short answer seems to be that getting more money does make people happier, if by getting more money we mean moving forward in relative terms.

When psychologists examine how subjective well-being varies with income within a country at a moment in time, the consistent finding is that richer people are, on the aver-

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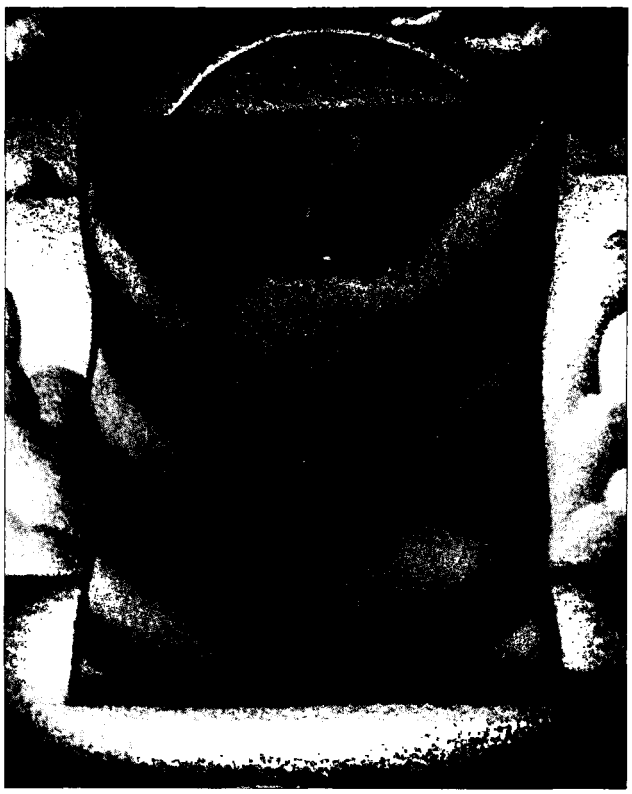
age, more satisfied with their lives than their poorer contemporaries. Note the striking contrast between this relationship and the evidence that average satisfaction levels remain constant as average per capita incomes rose manyfold over time within a country.



Measures of subjective well-being are not the only evidence that people care strongly about relative income. David Neumark and Andrew Postlewaite investigate how individual labor supply decisions depend on the incomes of important reference group members. The idea is that if someone cares strongly about how her income compares with the incomes of others, an increase in others' incomes will cause her to become more likely to seek employment or more likely to work longer hours if she is already employed. Unfortunately, researchers seldom have reliable data about the individuals whom people care most about.

Neumark and Postlewaite cleverly finesse this problem by asking whether a woman's decision about work outside the home depends on her sister's economic circumstances. According to economic orthodoxy, it would not. But the researchers find that women are 16 to 25 percent more likely to work if their sisters' husbands earns more than their own husbands.

Additional evidence for the strength of concerns about relative position comes from an elegant experiment known as the "ultimatum bargaining game." The game is played by two players, Proposer and Responder. It begins with Proposer being given a sum of money (say, $100) that he must then propose how to divide between himself and Responder. Responder then has two options: (1) he can accept, whereupon each party gets the amount proposed; or (2) he can refuse, whereupon each party gets zero, and the $100 goes back to the experimenter.

If both players cared only about their own absolute incomes, as assumed by economic orthodoxy, Proposer should propose $99 for himself and $1 for Responder (only whole-dollar amounts are allowed). And Responder should then accept this one-sided offer because getting $1 is better than getting nothing.

Yet this almost never happens. In one typical study in which the amount to be divided was $10, the average amount offered by

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Proposer was $4.71, and in more than 80 percent of all cases Proposer offered exactly $5. When Responders in this same study were asked to report the minimum amounts they would accept, their average response was $2.59. Most people seem predisposed to reject offers whose terms they find "unfair."

As in the laboratory, so in life. Concerns about relative position appear to account for a longstanding anomaly in the distribution of pay among workers within companies. According to economic orthodoxy, workers will be paid in strict accordance with the value of what they produce. The wage structure within most companies, however, seems far more egalitarian. Many companies follow strict salary formulas based on experience, education and length of tenure within the company, despite large and visible differences in the productivity of workers.

Here is a simple thought experiment. Among your co-workers of roughly similar rank, job title and seniority, try to envision the two most productive individuals and also the three who are least productive. Now suppose that either the top two or the bottom three were to disappear suddenly. Which group's absence would most reduce the total value of what gets produced in your group? Most people answer without hesitation that the disappearance of the top two would hurt most. On the basis of this answer, economic orthodoxy would predict that the combined salaries of the top two individuals would be greater than the combined salaries of the bottom three. Yet in most groups the reverse is true.

The apparent anomaly can be explained if we assume that, other factors being the same, workers prefer to work in companies in which they do not earn less than most of their co-workers. But if people are free to associate with whomever they please, why don't the lesser-ranked members of groups leave to form new groups in which they would no longer be near the bottom?

Some workers undoubtedly do precisely that. And yet we also observe many stable heterogeneous groups. What holds them together?

The apparent answer is that their low-ranked members receive extra compensation. If they were to leave, they would gain by no longer having to endure low status. By the same token, however, the top-ranked members would lose. They would no longer enjoy high status. If their gains from having high relative pay are larger than the costs borne by members with low relative pay, it does not make sense for the group to disband. Everyone can do better if the top-ranked workers induce their lesser-ranked colleagues to remain by sharing some of their pay with them. For the privilege of occupying top-ranked positions in those companies, they will have to work for less than the value of what they produce.

Even simple laboratory manipulations of relative position can have profound implications for market exchange. In one experiment, for example, researchers awarded half of their subjects stars on the basis of their performance on a transparently meaningless quiz. After these awards, subjects were given objects of known value and allowed to exchange these objects with one another for cash. The subjects who received stars consistently received better terms – that is, they bought at lower prices and sold at higher prices – when they exchanged goods with subjects who did not receive stars.

Further evidence that interpersonal comparisons are important comes from studies of markets for collectibles. In purely functional

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terms, a coin with a slight flaw is a perfect substitute for one that comes from the mint in perfect condition. As the market for rare coins attests, however, perfect substitutes are not always valued equally. The prices of flawed coins are often millions of times higher than those for otherwise identical coins that were minted in large quantities.

This finding is not merely the same as having documented the orthodox relationship in which the price people are willing to pay for a good is inversely related to the quantity they consume. If rarity per se truly didn't matter, the observed premium for flawed coins would be akin to finding that color-blind people are willing to pay much more for red toasters than for green ones.

Whatever positive consequences may flow from our concerns about relative position, it is clear that they are also the source of a great deal of misery. Some societies have attempted to avoid the unhappiness that results from unequal outcomes by trying to prevent unequal outcomes. Hence the Marxian distributional maxim: From each according to his ability, to each according to his need. Yet, as the collapse of the economies of the former Soviet Union has shown, preventing unequal outcomes to assuage concerns about relative position is a sure recipe for economic failure.

The explosive progress of the industrial economies of the West has been in no small measure the result of a generally shared cultural understanding that concerns about relative standing are not legitimate. This is not to say that people in the capitalist economies never experience a twinge of envy or resentment when an acquaintance succeeds on a spectacular scale. It is just that such feelings have never been seen as a legitimate basis for restricting the options of others.

Setting aside the question of whether it was ever sensible to stifle innovation in the name of equality, most observers recognize that this is no longer feasible. In the increasingly competitive global economy, those who are not rewarded will not take the necessary steps to innovate and those who fail to innovate will not survive. What is not generally recognized, however, is that the other extreme – complete intolerance of concerns about relative position – has itself proved a costly error, and not just in social terms, but in economic terms as well.

Preventing unequal outcomes to assuage concerns about relative position is a recipe for economic failure.

LUXURY WITHOUT APOLOGY

Excessive environmental pollution is caused by an incentive gap virtually identical to the one that gives rise to excessive conspicuous consumption. And once we understand the link between these two problems, we can use the lessons in the environmental domain to help craft better solutions to the problem of conspicuous consumption.

Consider an individual weighing the decision of whether to drive to work or take the bus. This person has no reason to believe that his decision will have any measurable impact on air quality in his city. If driving to work is considerably cheaper, or more convenient, he will drive. But when millions of motorists

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simultaneously reach the same conclusion on this basis, the impact on air quality is far from negligible.

Note the virtually identical incentive gap in the job seeker's decision about whether to buy a custom-tailored suit. His natural focus is on whether the suit will increase his odds of landing the job he wants by enough to compensate for its extra cost. If the contest for the job is likely to be close, it will be worth it for him to spring for the better suit. This is problematic because when other job seekers simultaneously reach the same conclusion, the extra expenditures go for naught.

Our first attempts to solve the problem of excessive pollution were much like our first attempts to solve the problem of excessive conspicuous consumption.

The Clean Water Act of 1971, for example, established a deadline by which each producer had to remove 90 percent of its base-year emissions of toxic wastes flowing into the nation's rivers. By issuing an across-the-board prohibition on specific acts of pollution, this law was essentially like the early sumptuary laws, which issued across-the-board prohibitions on specific forms of consumption. And the problems with both approaches are strikingly similar.

One wasteful aspect of the sumptuary laws was the indiscriminate way they required cutbacks in consumption, even from those with a passionate attachment to the forbidden product. The original Clean Water Act was wasteful in an exactly parallel way. Whereas the goal of an intelligent environmental policy is to achieve a reduction in pollution at the lowest possible cost, the Clean Water Act required the same 90 percent cutback from producers for whom curtailment was costly as from others for whom curtailment was cheap.

Trying to micromanage individual companies' pollution-abatement efforts generally results in wasteful outcomes, a lesson that has at last been absorbed by environmental policy analysts. Instead of requiring equal cutbacks on the part of each company, they now focus on policies that reduce a concern's incentive to pollute by taxing it on the basis of how much it pollutes. This provides each company with an incentive to cut back its pollution in the most cost-effective way it can.

In a hypothetical world with only a single conspicuous-consumption good – say, cars – the analogy between luxury taxes and pollution taxes would be virtually exact. The problem in each case is that we have too much of something in the absence of collective action – too much conspicuous consumption good in one case, too much pollution in the other. Each problem exists because of an incentive gap. Both conspicuous consumption and activities that pollute are more attractive to individuals than they are to society as a whole.

With a tax on the luxury good, people would have an incentive to spend less of their incomes on it – just as, with a tax on pollution, companies have an incentive to pollute less. Note that in both cases, the tax tends to distribute the burden of adjustment in a fair and efficient manner. Just as a pollution tax concentrates pollution abatement in the hands of those who can accomplish it most cheaply, so a luxury tax concentrates the reduction in conspicuous consumption in the hands of consumers best equipped to adjust. Those who don't care much about cars will find that their best bet is to scale back their automobile expenditures significantly. And those for whom such cutbacks would be most painful will elect to pay the tax to continue to pursue their passion.

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However, there is not just one conspicuous good but many. If we taxed bright silks, people would simply move to gold buttons, just as the medieval Europeans did. To complicate matters further, what is a conspicuous-consumption good for one may not be for others. And to attempt to use the political process to classify specific goods as luxuries is to invite a free-for-all. Fortunately, however, we can attack the problem without having to settle such questions on a case-by-case basis.

THE PROGRESSIVE CONSUMPTION TAX

Because we ignore the fact that our own spending influences the definition of an acceptable living standard, private consumption seems more attractive to us as individuals than to society as a whole. The simplest solution is to make those forms less attractive by taxing them with a single levy on the total amount that families spend each year.

Here's how a progressive consumption tax would work if the first $7,500 per person were exempt from tax. With a total deduction of $30,000 per year, a family of four whose income was less than $30,000 (plus the amount it saved) would owe no tax. It could purchase basic necessities – defined not by legislators but by its own members – tax-free. Once the family's total consumption passed the taxable threshold, it would then begin to pay tax on each additional dollar of consumption, at a progressive rate. The tax on families with positive taxable consumption might begin at 20 percent and then gradually escalate.

There is reason to believe that even the wealthiest people would respond to such tax signals. For example, in Manhattan, where real estate prices are several times higher than in most other American cities, the wealthy buy much smaller houses than their counterparts elsewhere. Whereas even a 5,000-square-foot brownstone is expansive by the standards of the wealthy residents of the Upper East Side, people with similar incomes in Los Angeles often buy 10,000- or even 15,000-square-foot houses.

Yet an American chief executive needs a 15,000-square-foot mansion only because others of his station in life have houses that large. To have a lesser dwelling would risk social embarrassment or raise questions about the health of his business. Yet if all chief executives were to build smaller houses, no one would be embarrassed in the least. Indeed, many chief executives might even prefer to have smaller houses.

Just as high real estate prices lead the wealthy to buy smaller houses, a steeply progressive consumption tax could lead them to spend less on automobiles. The erstwhile Ferrari driver, for example, might turn instead to the Porsche 911 Turbo, which currently sells for "only" $105,000. The 911 is even faster than the Ferrari, and it is also more surefooted. Its only real drawback, from the perspective of the ultrarich, is that its bargain-basement price has made it an almost common sight in the circular driveways of many neighborhoods. Under a progressive consumption tax, the Porsche would acquire precisely the rarefied status of today's exotic cars, which was all that kept it from being attractive to Ferrari buyers in the first place.

If a progressive consumption tax affected only the spending decisions of the superrich, its benefits would be minimal. But such a tax would have much broader impact. Indeed, it would produce a cascade of similar savings all the way down the consumption pyramid. If we continue for several more decades on our current trajectory, the replacement for today's

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Ferrari 456 GT will sell not for $207,000 but for more than $400,000. Those who are content to drive the $105,000 Porsche 911 Turbo today will move up to a car something like the Ferrari 456 GT. Likewise, those who drive the $72,000 Porsche Carrera today will move up to a car like the 911 Turbo. The current drivers of the $45,000 Porsche Boxster will trade up to a car like the Carrera.

If we take no action, these upgrades will inexorably occur, as will others like them in other domains. A future version of the Patek Philippe Calibre '89 wristwatch, for example, will command twice its current price of $2.7 million. And tomorrow's Hermes Kelly alligator handbag will cost not $14,000 but $28,000.

By contrast, with a phased introduction of the progressive consumption tax, the amount of resources devoted to producing these goods can be held near their current levels. The point is not to put companies like Ferrari and Patek Philippe out of business, but simply to slow the rate at which additional resources are devoted to making all products – not just theirs – more opulent.

All incentives are relative, and because the progressive consumption tax makes it more costly in relative terms to engage in conspicuous consumption, it also makes it less costly to engage in inconspicuous consumption. For example, because the tax would mean that an additional dollar of cash wages would buy less, employers have an incentive to rearrange their compensation packages to emphasize untaxed quality-of-life benefits – an extra week of vacation, a more private space at work.

Because the amount of additional goods people can buy by working longer hours would decline under a progressive consumption tax, they would have an incentive to work fewer hours and spend more time with family and friends or just reading a good book.

The catch? There is none. The extraordinary beauty of the progressive consumption tax is its ability to generate extra resources almost literally out of thin air. It is a win-win move, even for the people on whom the tax falls most heavily.

So why don't we already have a progressive consumption tax? Such a tax faces a critical political hurdle – namely, the belief that imposing sharply higher tax rates on the nation's most wealthy and productive citizens is a surefire way to cripple the economy. Although this belief is most deeply entrenched among conservatives, it has also won widespread acceptance among liberals. Indeed, it is no exaggeration to call this the single most influential belief driving economic policy in the late 20th century. It was responsible, for example, for the dramatic reductions in the tax rates on top earners in both Britain and the United States during the Thatcher and Reagan administrations.

It is natural that voters find tax increases distasteful, and the belief that they will harm the economy has provided politicians with an irresistible opportunity to denounce them. Indeed, the risk inherent in proposing even a modest tax increase cannot have escaped the attention of any politician with a pulse.

On the best available evidence, however, a steeply progressive consumption tax would not cripple the economy; it would actually invigorate it. Yet it is what people believe about reality, rather than reality itself, that governs public policy decisions. And as long as the fundamental premise of trickle-down economics remains an entrenched part of the received wisdom, the adoption of a steeply progressive consumption tax will remain a long shot. MI

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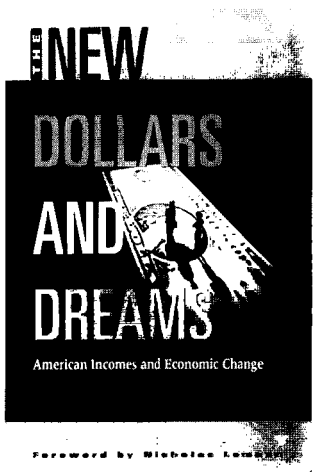
Inequality has become something of a growth industry. Dozens of books on income disparities – from *The Bell Curve* by Richard Herrnstein and Charles Murray to *The Winner-Take-All Society* by Robert Frank and Philip Cook – have appeared in the past few years. The latest is *The New Dollars and Dreams* by Frank Levy, a labor economist at the Massachusetts Institute of Technology.



The New Dollars and Dreams: American Incomes and Economic Change

by Frank Levy

Russell Sage Foundation, 256 pp., $39.95 cloth; $16.95 paper

Reviewed by Sylvia Nasar

As the title implies, Mr. Levy's new book is a sequel. *Dollars and Dreams*, published a decade ago, argued that the living standards of average Americans fell in the 15 or so years following the 1973-74 oil crisis. The new version retreats from the original thesis that Americans were trapped in "a quiet depression." This characterization, Levy now concedes, was "excessive." After all, consumption per person rose faster in the 1970's and 1980's than during the Eisenhower years. While the economy didn't grow as rapidly, Americans worked harder and (with the help of credit cards and home equity mortgages) managed to boost their spending by more than one third in each decade.

These days the economy is perking along about as well as it did in the good old days of the 1960's. Inflation and unemployment are back to pre-oil-shock levels. Productivity growth has recently edged back up to long-run historical trends (1.6 percent), and the real wages of most workers have been growing briskly.

However, Levy has another bone to pick: the widening gap between rich and poor. That gap shrank from the 1930's through the 1970's, but has been growing for the past 20 years. The top 5 percent of families captured 20.3 percent of the nation's income in 1996, up from 15.3 percent in 1979. The bottom 20 percent, meanwhile, saw their share fall by one-fifth – from 5.4 percent to 4.2 percent. If the trend toward greater income inequality continues, writes Nicholas Lehmann, the respected chronicler of social economy, "we may be seeing the emergence of the kind of

SYLVIA NASAR, a reporter for *The New York Times*, is the author of *A Beautiful Mind* (Simon and Schuster).

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hard class system that has never existed in this country."

The chief culprit, argues Levy, isn't one of the popular suspects – the shift to service jobs, globalization or the Reagan tax cuts – but the Computer Age itself. For two decades, the demand (and hence, pay) for less skilled, less educated workers has grown much more slowly than for the highly skilled and educated. The trend is remarkably pervasive and stretches across industries, occupations and countries. "People with no more than high school education are frequently viewed as downscale in both commercial and social terms," writes Levy, and "many of today's older workers have not seen significant income gains over their careers."

Levy does link some of the increase in inequality to Washington's liberal stance on welfare and crime. He singles out Great Society policies that gave states incentives to expand welfare caseloads and to make dependence a more acceptable condition. This, he argues, made it possible – and socially permissible – for young, single women to have babies. In addition, he cites research tying the explosion of crime in the 1960's to the collapse of both work opportunities and the work ethic among young black men.

None of Levy's points are especially new. But his evenhanded, careful and concise summary of what economists know about the changes in income distribution over the past 20 or so years is still very useful.

He fails, however, to buttress his claim that the current degree of inequality – as distinct from the phenomenon of an entrenched underclass – is a major problem for the country. True, incomes are less equal than they were in 1947 or in 1977. But they're far more equal than they were in the 1920's. Income disparities have widened, but other kinds of inequality – between men and women, blacks and whites – have narrowed dramatically. Many Americans, surely, would choose to live with today's income distribution over the one that prevailed a half century ago.

It's also true that a smaller fraction of families have "middle class incomes," which Levy defines as $30,000 to $80,000 a year. However, a much larger fraction share the goals of the middle class – college attendance, work, home ownership – and fewer seem stuck in a culture of poverty, crime and dependency. Which is more important?

In short, Levy's honest and balanced presentation of statistical evidence – as well as the economy's recent performance – keeps getting in the way of the story he's trying to tell. He concedes that if productivity continued to grow at its recent pace and the "skill bias" in favor of educated workers stopped widening, inequality would no longer be so problematic.

What he really fears is "the reduction of common interests." He's referring not to middle class behavior and beliefs but to the decline of the social welfare state. The welfare state, Levy argues, is based on the notion of "there but for the grace of God." If the haves no longer identify with the have-nots, they may no longer support programs that compensate the economy's losers. That, in turn, he suggests, could give rise to a new, destructive, class politics in which less favored Americans abandon pro-growth, free-market policies.

Again, though, Levy's facts don't justify his fears. The welfare state seems in no danger of withering away; government payments to individuals are a higher share of national income than ever, and reforming public education and Social Security are among voters' top concerns.

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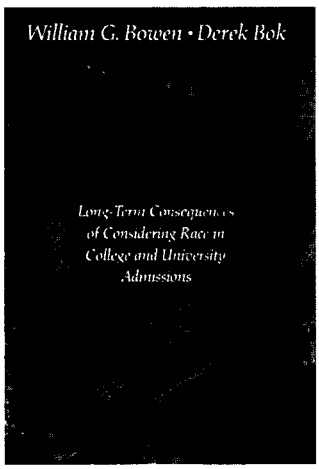
Read *The New Dollars and Dreams* for its crystal-clear analysis of where we are and where we have been. Take the jeremiad about where we are going with a grain or two of salt.

ESTEEMED DONS DURING Camelot and the chaotic 1960's, William Bowen and Derek Bok later became the presidents of Princeton and Harvard respectively – the very symbols of progressive Atlantic gentility. Bowen is now the president of the Andrew W. Mellon Foundation, while Bok is professing at Harvard's Kennedy School of Government. Their new book, *The Shape of the River*, is built around Mellon's vast database, which was used to track some 80,000 undergraduates who entered 28 academically selective colleges in the autumns of 1951, 1976 and 1989.

The title is taken from Mark Twain's *Life on the Mississippi*: "You've got to know the shape of the river perfectly. It's all there is left to steer by on a very dark night." It reflects the writers' belief that an individual's education, career and place in the community follows something more like the winding course of a river than a smooth passage through a pipeline.



The Shape of the River: Long-term Consequences of Considering Race in College And University Admissions

by William G. Brown and Derek Curtis Bok

Princeton University Press, 472 pp., $24.95

Reviewed by Rebecca Ford

For a generation, debaters on affirmative action have relied on anecdotes to make their cases. Bowen and Bok use statistical methods to examine the admission and performance of black students at selective colleges and the impact of that experience on their lives. Multivariate regressions allow the researchers to examine individual factors – earnings, test scores, graduation rates, post secondary degrees, civic participation – not to mention satisfaction with college and interaction with members of other races.

This journey begins with the admissions minuet. Most colleges do not have affirmative action programs because they do not have enough applicants from which to pick and choose. Only about one-fifth, with distinguished academic programs, have this luxury.

Selecting the members of an incoming class in an Ivy League school, it seems, is like planning a party. Adequate grades and SAT scores are required, but the applicant must also bring some distinctive trait to the table. The most sparkling students are wanted – a group in which each member will enhance the experience of the others. To survive the initial screening, an applicant must surmount the relatively modest threshold of demonstrating an ability to graduate. After this first cut, though, the going gets tougher: Schools weigh promise of academic excellence, diversity of backgrounds and talents, likelihood that the applicant will make a special contribution to a profession or to society.

REBECCA FORD, lawyer and film producer, is the president of the Istonford Corporation, an independent film company.

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Institutional continuity counts, too, with preferences for alumni and faculty. With a surfeit from which to chose, schools turn away applicants whose profiles are very similar to those admitted.

Preferences for blacks appear to have minor impact on white applicants. Indeed, Bok and Bowen found that if race-neutral policies had been applied, a white applicant's probability of admission to the colleges surveyed would have risen from 25 percent to just 26.5 percent. On the other hand, African-Americans admitted per class would plummet from 6.8 percent to 2.4 percent.

Why, then, the heated debate over a paltry 1.5 percentage points? Thomas Kane, an economist at the Kennedy School, offers the analogy of handicapped parking: "Eliminating the reserved space would have only a minuscule effect on parking options for non-disabled drivers. But the sight of the open space will frustrate many passing motorists who are looking for a space. Many are likely to believe that they would now be parked if the space were not reserved."

What of the argument that blacks admitted to selective institutions as a result of preferences are penalized by the stigma? Only a small percentage of black matriculants interviewed, including dropouts and transfers, expressed dissatisfaction with their experience. Moreover, neither black nor white students whose academic credentials were below average later paid a penalty in terms of success in the marketplace. Everyone, it seems, benefits from an elite education.

In the end, the best advice for blacks and whites is to get good grades. Household income was found to be the greatest predictor of life satisfaction for all participants, and grades had the most powerful independent effect on annual earnings. Bok and Bowen's research confirmed the earnings gaps between men and women, blacks and whites. Nevertheless, the authors found that "the large premium associated with doing well academically, like the premium associated with attendance at the more selective schools, is unaffected by the introduction of controls for SAT scores, socioeconomic status, type of school attended, field study, advanced degrees held, and sector of employment."

The authors' most surprising finding was that the college grades of minorities, especially blacks, is significantly lower than their standardized test scores would predict. More startling yet, African-Americans who would have been admitted under a race-blind policy perform the farthest beneath the level predicted by pre-college testing. Some, I would argue, are demoralized by subtle prejudice: the "Iago effect" of consistent negative feedback based on assumptions about a group can become self-fulfilling prophecy.

In an environment in which overt racial animus is largely absent, racial preferences that exclude blacks, not the ones that include them, can be most demoralizing. Although written in a very different context, Jean Paul Sartre's words apply: "[H]e never encountered any particular resistance; people seem, rather to be in flight before him; an impalpable chasm widens out, and, above all, an invisible chemistry devalues all he touches."

The Shape of the River uses quantitative analysis to show that the benefits of affirmative action admissions outweigh the costs. *A Hope in the Unseen* adds human dimensions to the argument.

Ron Suskind, a writer for the *Wall Street Journal*, won a Pulitzer Prize for two long articles he wrote on the high school years of Cedric Jennings. Suskind first met Jennings in

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1994, when he was a junior at Ballou High School in Washington, D.C. The book that grew out of the articles incorporates the high school material and follows Jennings through his first year at Brown University.

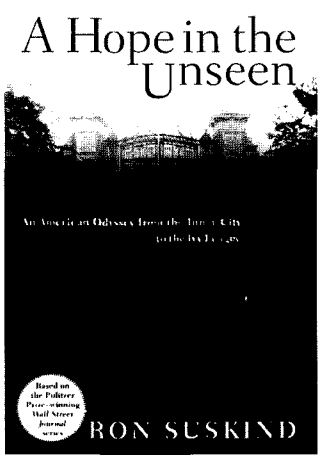
At Ballou, Jennings is harassed for his academic achievement. If he changed, he would be accepted – no question. Other once-achieving black males have successfully reaped social acceptance by repudiating academic performance. When this line is crossed, however, it's not clear one can step back.

Despite his abysmal SAT scores, Jennings gets early admission to Brown University. Brown admits its share of affirmative action candidates, then leaves them to sink or swim. Jennings sinks – but rises again to the surface.

Suskind helps us to understand Jennings by providing fleshy profiles of the dozen or so people who touched his life in important ways. Indeed, the book reads like a college dorm episode of the *Real World* MTV series, with Jennings the star of the show.

At Brown, the value and reward system is the opposite of everything he has been taught. At home, he lived monastically, buoyed by faith that God would reward his self-sacrifice and clean living. At Brown, he is surrounded by contemporaries who are drinking, drugging and fornicating – and still running circles around him academically.

Jennings isn't entirely alone, though. He has a guardian angel, Donald Korb, a contact lens mogul in Boston who discovered Jennings through the *Journal* articles. Korb sends Jennings an allowance, pushes him to a writing tutor and even gives Jennings a seersucker suit to wear to his summer job. (The gesture is lovely but, of course, no self-respecting 17-year-old wears seersucker in southwest Washington.)



A Hope in the Unseen: An American Odyssey From The Inner City to the Ivy League

by Ron Suskind

Broadway Books, 372 pp., $25.00

Reviewed by Rebecca Ford

A highlight of the book is Jennings' relationship with Zayd Osceola Ayers Dohrn. Selective schools seek students with extraordinary backgrounds who will expose others to new experiences. And Zayd Dohrn is almost a caricature of their dream candidate.

Dohrn is the son of two Chicago college professors. Not just any professors, but Bernadine Dohrn and Billy Ayers, leaders in the 1960's of the revolutionary splinter of the Students for a Democratic Society called Weather Underground. In watching these two young men interact, it becomes clear that Jennings is there for Dohrn to sharpen against, not just the other way around.

By the end of the book Jennings is well along to resolving his ambivalence about leaving his former life behind. If Bowen and Bok are right, it's likely he will graduate, attend graduate school and look back at college as a positive experience. He will earn more than comparably gifted black men from less selective institutions – but not as much as the white guys. Projecting this young man's prospects seems easy enough, but the million curves and variations of shape in the banks and shoals of Jennings life have yet to be fathomed. M

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The world largely ignores the flood of economic research pouring from universities, think tanks and government agencies. And with some reason: most of it is irrelevant to public policy or is compromised by inadequate data, arbitrary assumptions or flawed statistical methods.

By the same token, relevant research often takes too long to surface or is lost forever in the clutter of competing analyses. In the first of what will probably be a regular feature in *The Milken Institute Review*, I offer a sampling of significant work that has not risen out of the economist's ghetto of scholarly journals and institutional working papers. Tips from readers on published or unpublished research that deserves to break free from the clutter are welcome.

The Bank Strikes Back

East Asia's failure to bounce back from the currency crisis has stirred a backlash against the International Monetary Fund's traditional prescription of fiscal and monetary austerity as the cure for financial panic. Joseph E. Stiglitz, the World Bank's chief economist, led the chorus of complaints, arguing that remedies developed for Latin America in the 1980's were inappropriate for Asia in the 1990's, before his more diplomatic superiors muzzled him. But the bank hasn't been entirely silenced. In a recent unpublished (but easily obtainable) working paper, three bank economists – Wei Ding, Ilker Domac and Giovanni Ferri – join the battle with an analysis of how tight money has undermined prospects for recovery in Indonesia, Korea, Malaysia, the Philippines and Thailand. While their conclusion is couched in the neutral jargon of economics, it still adds up to a big, fat raspberry directed at the I.M.F. [*"Is there a Credit Crunch in East Asia," World Bank Working Paper 1959, August 1998. Downloadable from www.worldbank.org*]

THE PRICE OF GOOD INTENTIONS

The Americans With Disabilities Act of 1991 banned discrimination against the disabled and required all but the smallest employers to accommodate disabled workers. As with other government mandates that affect the cost of labor, though, there is a risk that this one will price marginally qualified workers out of the market. And, alas, Daron Acemoglu and Joshua Angrist of M.I.T. have confirmed that risk.

For 1993, the first year in

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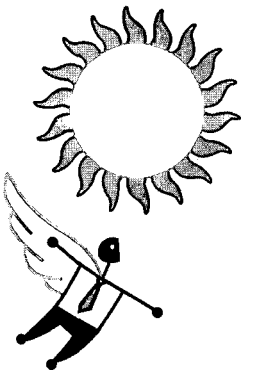
which the act was fully implemented, they found substantial, otherwise unaccountable drops in employment for both disabled men and women. The increased legal protection against discrimination in the new law apparently didn't offset the added financial disincentives to hiring the disabled in the first place. [*National Bureau of Economic Research Working Paper 6670, July 1998. Call 617-868-3900 for copies.*]

BRYAN LEISTER (3)

DUNNING DELINQUENT DADS

The explosion of single-parent, female-led households in the 1970's and 1980's is widely seen as a primary cause of child poverty in America. Both the states and the feds responded with a flurry of legislation and administrative fixes intended to force fathers to share the cost of raising their progeny. And according to Richard Freeman of Harvard and Jane Waldfogel of Columbia, the effort is paying off. The percentage of never-married mothers receiving child support has risen sharply. What's more, the authors estimate that increased outlays on enforcement programs between 1990 and 1995 account for one-fifth of the gain. [*National Bureau of Economic Research Working Paper 6664, July 1998*]

The Not-So-New Economy



Just a few years ago, anyone who claimed that America could sustain 2 percent inflation in the midst of a labor shortage would have been drummed from the ranks of the Dismal Scientists. Ever since the impossible happened, though, economists have been grinding out explanations, most of which revolve around globalization.

Geoffrey Tootell of the Federal Reserve Bank of Boston takes on one of the most popular explanations – namely, that excess capacity in the economies of our trade partners curbs corporate pricing power at home. He finds little evidence that foreign industrial capacity utilization has had an impact on United States import prices and little reason to believe that falling import prices have been passed through to consumers. Tootell is thus firmly in the pessimists camp: "Anyone who believes in a world where we need no longer worry about domestic capacity constraints," he predicts, "will eventually be rudely awakened by data that suggest otherwise."

[*"Globalization and U.S. Inflation," New England Economic Review, July-August 1998. Downloadable from www.std.com/frbbos/economic/neer/neer.htm*]

THE CURSE OF DISEASE

With few exceptions, most of the world's nations now seem destined to grow their way to prosperity. Jeffrey Sachs, the director of Harvard's Institute of International Development, has become increasingly preoccupied with those exceptions – the few dozen losers that have apparently been left without a reserved seat on the global gravy train. One common factor in their failure, he argues, has been the heavy burden of disease – in particular, of malaria. In a paper written with John Gallup of Harvard, Sachs estimates that widespread incidence of malaria cut economic growth rates between 1965 and 1990 by a stunning 1.3 percentage points. The good news: A 10 percent

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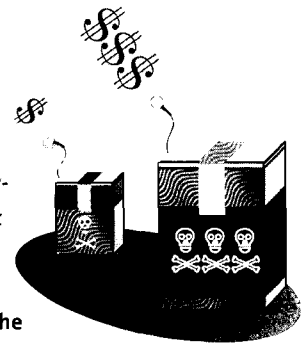
Smoke Enders



Strip away the indignation about corporate greed and the best argument for slapping a heavier tax on tobacco is the deterrent effect on teen smoking. Higher prices do seem to reduce the number of cigarettes bought by the young. There's a catch, though, report William Evans of the University of Maryland and Matthew Farrelly of the Research Triangle Institute. It seems that smokers aged 18 through 24 fully compensate for higher prices, sustaining addiction by switching to higher tar and nicotine brands. If we're really serious about using taxes as a way of reducing the health hazard (as opposed to raising revenue), the authors argue, tax rates ought to be tied directly to the noxious content of cigarettes. [*"The Compensating Behavior of Smokers," RAND Journal of Economics, Autumn 1998. Downloadable from www.rje.org*]

reduction in malaria incidence in these countries is statistically associated with a (substantial) increase in the rate of growth of three-tenths of a percentage point. [*"The Economic Burden of Malaria," HIID Working Paper, October 1998. Downloadable from www.hiid.org.*].

THE CURSE OF DRINK

Mothers Against Drunk Driving has provided a rationale for the New Prohibitionism in America. In case everyone hasn't absorbed the message that immoderate consumption of alcohol is bad, Sara Markowitz of the New Jersey Institute of Technology and Michael Grossman of the City University of New York offer some more bad news: Alcohol is closely linked to child abuse.

Wait, there's a silver lining. Since the price of beer has a substantial impact on total alcohol consumption by potential abusers, beer taxes could make a big difference in the body count. Indeed, the authors estimate that a 10 percent increase in the beer excise tax would reduce the number of severely abused children by about 130,000 annually. [*"Alcohol Regulation and Domestic Violence Towards Children," Contemporary Economic Policy, July 1998. Call 562-985-5069*]

THE AGE OF ANXIETY, PART I

If you believe anecdotal news accounts, job security declined sharply in the 1990's. If you believe President Clinton's Council of Economic Advisers, there has been little change in job tenure. Using the latest census data, David Neumark of Michigan State, Daniel Polsky of Penn and Daniel Hansen of Laurits Christensen Associates find that involuntary separations did rise a bit in the 1990's. More damning, they unearth evidence suggesting that job security for workers in mid-career has fallen substantially since the 1980's.

THE AGE OF ANXIETY, PART II

What people think about job security counts almost as much as the reality in determining how hard they fight for higher wages and benefits. And here, Stefanie Schmidt of the Urban

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Institute and Christopher Thompson of Countrywide Home Loans offer the latest intelligence. Combining data from a variety of polls, they found that workers were indeed more worried about losing their jobs in the period 1990-1996 than in other periods of comparable unemployment. But since 1996 these fears have subsided, leaving workers no more anxious today than they were in the 1980's. [*Both research papers will be printed in a book, to be published by the Russell Sage Foundation in 1999. To obtain unpublished drafts, apply to the authors.*]

POVERTY PROVOCATIONS

Back in 1989, Dale Jorgenson of Harvard shocked liberals (and probably undermined his prospects for a Nobel Prize) by asserting that poverty was a far less serious problem in America than conventional measures would suggest. A pair of essays by Jorgenson and Robert Triest of the Federal Reserve Bank of Boston rejoins the issue and brings the numbers up to date. While those who followed the debate from the beginning won't be surprised, the point-counterpoint essays do a fine job of illuminating the difficulties in both defining poverty and measuring it. [*"Measuring Poverty," Journal of Economic Perspectives, Winter 1998*]

PRICING HIGHWAYS

Soviet bureaucrats found out that when bread was free, farmers fed it to the livestock. Likewise, urban planners in America have discovered that when road use is free, traffic becomes unmanageable. The Russians have since turned to markets to set the price of bread, but American planners face bitter opposition to a parallel reform – "congestion pricing" for highways.

To get around this entrenched opposition, California decided to charge tolls on new lanes added to an existing highway. Trouble is, say Louie Nan Liu of Berger Consultants in New Jersey and John McDonald of the University of Illinois at Chicago, the efficiency gains from this experimental half-measure are puny compared with the potential gains from imposing tolls at rush hour on all lanes. Some day, some way – but apparently not yet – American commuters are going to have to face up to the reality that it is less painful to pay cash for highway use than to spend their lives stuck in traffic. [*"Efficient Congestion Tolls in the Presence of Unpriced Congestion," Journal of Urban Economics, November 1998*]

CHEAP MEDICAL CARE

A horse is a horse, of course of course. But what about a computer, a car – or the treatment for a killer disease? Economic statisticians have long been aware of the difficulties in adjusting price indexes for changes in quality, especially in cases like medical care, where technology is progressing rapidly. Indeed, the effort to build a better consumer price index may well become a political football in the coming battle over reform of government entitlement programs, notably Social Security. Now David Cutler (Harvard), Mark McClellan (Stanford), Joseph Newhouse (Harvard) and Dahlia Remler (Tulane) have entered the fray with an analysis of the changing cost of treating heart attacks. A proper accounting, they say, lowers the rate of inflation by three percentage points annually. [*"Are Medical Prices Declining?" Quarterly Journal of Economics, November 1998*] M

–Peter Passell

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While feuding over how to respond to the global financial distress that began with the collapse of East Asia, multilateral lenders agreed on the need for rigorous accounting standards requiring banks to reveal their assets, liabilities and loan-loss provisions. But this entirely sensible prescription begs a critical question: Why have otherwise-competent governments in emerging economies not produced well-regulated banking systems on their own? **BY HILTON ROOT**

One answer is that the interests of their leaders are often quite different from those of the public. In fact, financial mismanagement, culminating in the plundering of the banks and the suppression of alternative capital markets, is often part of a political survival strategy – one not easily surrendered to faceless liberal forces the government can't control. Unless reformers recognize this fundamental misalignment of interests and find ways to overcome it, reforms are bound to be frustrated.

It should hardly be news that many of the world's leaders maintain their grip on power by manipulating access to economic resources – capital, technology, infrastructure – insuring that key supporters are rewarded. Oddly, though, the resulting waste is often ignored by those who plead for international financial support for discredited regimes.

Defending the $4.8 billion dollar International Monetary Fund loan to Russia that went sour last summer, Larry Summers, Under Secretary of the Treasury, reasoned that the United States took a calculated risk "because it was vastly better that Russia succeed than not succeed." The cash was intended to foster financial-sector reform. Instead, according to the I.M.F. official who brokered the deal, the $4.8 billion was squandered, only propping up the currency long enough to "let the oligarchs get their money out of the country." What Summers apparently did not appreciate was that the interests of the rulers and the interests the country are not the same, and that institutions to make Russia's rulers accountable to the Russian people do not exist.

A quarter-century ago, leaders of East Asia's high performers, preoccupied with the question of national survival in an era of Communist expansionism, made sure that resources were invested in development and growth. However, the evolution of China from "threat" to "economic competitor" undermined the imperative to maximize the efficiency of investment. As wealth and prosperity increased, maintaining political power became an end in itself and supervision of national financial systems declined.

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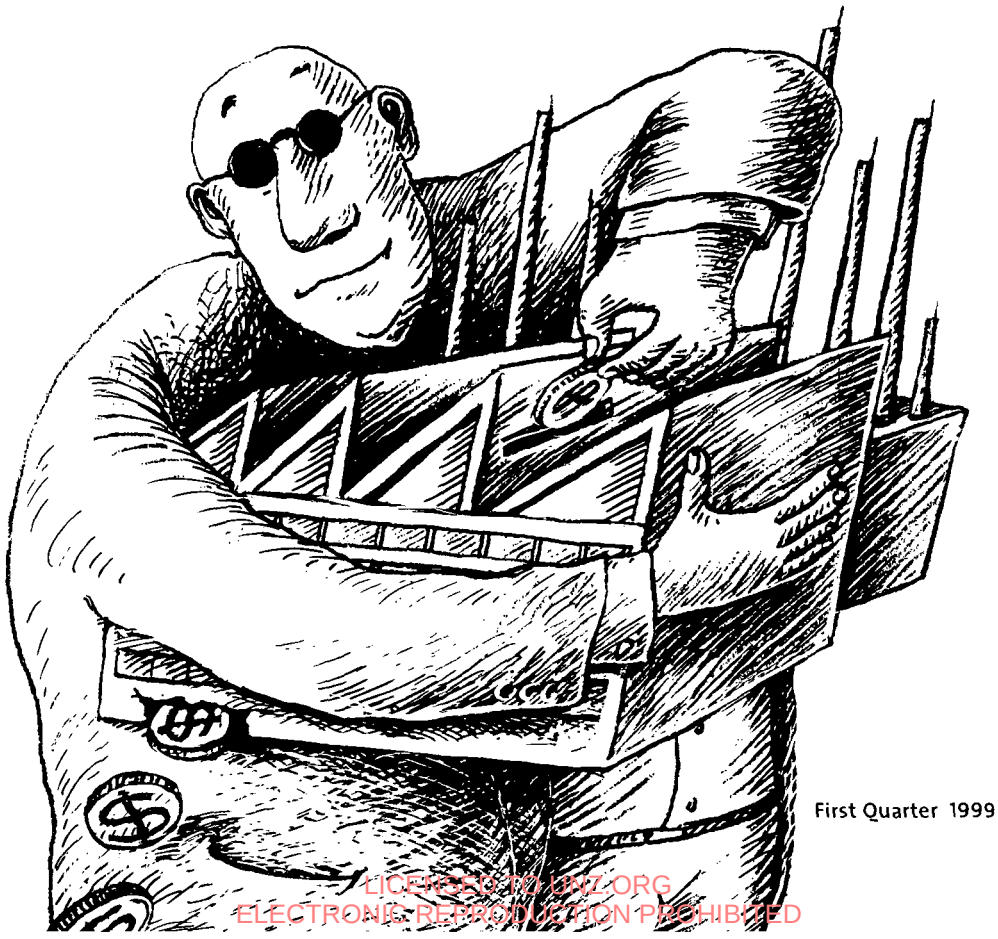
The evolution of the Korean economy illustrates the consequences. Politicization of the banking sector effectively guaranteed gigantic conglomerates, known as chaebols, access to cheap capital. This allowed the chaebols to pursue market size as an end in itself, even as they poured money into loss-making business units. The resulting overcapacity has brought the Korean economy to the brink of disaster, though it has not derailed the conglomerates. In fact, the top five have actually toughened their grip, dumping worthless assets and consolidating the jewels as part of a much-heralded industrial rationalization plan.

Political favoritism in bank lending similarly allowed the friends and relatives of Indonesia's former President Suharto to loot the economy of one of the world's potentially richest nations. Now the entire banking system must be recapitalized. If Indonesia follows the path that Mexico took two decades ago, we can expect that, once the banks have been nationalized, they will be sold back to their original owners at scandalous discounts.

Japan, like Korea, features a financial system in which loan decisions are not disciplined by market forces. The cost of capital for Japanese companies has been artificially reduced by a combination of government policy and less-than-arms-length relationships with banks. Since the big companies financed development with borrowed funds rather than equity, they were able to measure performance by market share rather than profitability. Many observers believe that Tokyo has dragged its feet on full disclosure of the assets and liabilities of the banking system out of fear that political malfeasance would be exposed.

Ironically, while international organizations supported by Japan promote trans-



JERZY KOLACZ

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parency as the universal medicine for misallocation of capital, Japan's own Ministry of Finance has found a way to circumvent good accounting practices. It caps the amount a private company can spend on outside audits. Then, if fraud is later exposed, the accountants, handicapped from the outset, can be blamed.

The crises in public finance of the world's most promising emerging markets are often rooted in their political culture and institutions. Throughout the world, badly regulated banking is often part and parcel of a failed system of governance. The obstacle to international growth once posed by central planning has been replaced by a subtler threat: deliberate mismanagement.

There is no better indicator of rule by mismanagement than the failure to identify and enforce tax liability. Is it any surprise that the great debtor countries in the world collect so small a percentage of the taxes they are owed? Of the estimated 73 million Brazilians in the work force, only 7.6 million pay income taxes. Out of a population of 140 million in Pakistan, just 1 million pay income taxes. Tax evasion among Mexico's 15.7 million black-market vendors cost the Treasury the equivalent of $2.7 billion in 1997. The Philippines collects taxes from only 2 million of 12 million possible taxpayers.

These same debtor countries share another dubious distinction: Their citizens have stashed vast amounts overseas, often more than the total international debt owed by their governments. Meanwhile ordinary citizens hide their fortunes under mattresses, so that the banking system cannot effectively mobilize national capital reserves. An estimated $60 billion is secreted this way in Russia.

The countries that lead the world economy today did not always pass the basic test of fiscal accountability. In the not-so-distant past, the distinction between public and private had little meaning in France, Britain or Japan. In time, though, rulers desperate for revenue were driven into the hands of their own citizens, who insisted on oversight in exchange for their taxes. The separation of the leader's private interests from the interests of the state was thus driven by fiscal imperatives. The state became a separate power and the age-old identification of the ruler and the state, l'état c'est moi, was surmounted.

By contrast, the financial architecture used to solve today's global economic crises allows leaders to draw support from international organizations without engaging the will of the people who must ultimately pay back the loans. This form of taxation without representation is an anachronism that reinforces governance without accountability. It contributes to a fundamental misalignment of economic incentives: the benefits are largely private, the debt is public and sovereign.

International bailouts create a political variation on classic "moral hazard," encouraging leaders to take extreme risks with their nation's finances and later passing the costs along to citizens in the form of debt overhang. Inadvertently, international intervention contributes to the private economic fortunes that perpetuate political domination by the individuals who benefit most from their countries' ruin.

Is it any wonder, then, that the populist opposition in emerging markets typically sees the I.M.F. as an enemy? Any reform of the world's financial architecture is virtually certain to fail unless it establishes the rights of citizens as stakeholders in their nation's future. M

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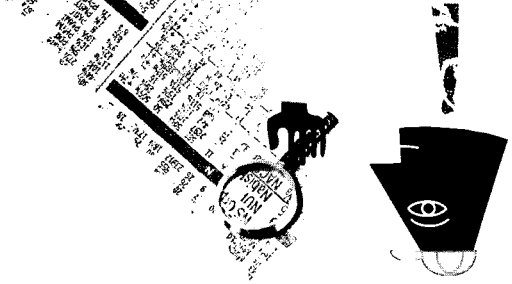

Quiz Answers

1. All of the above. Of course, bond-rating services haven't been around since the beginning of time. If they had been, at least Alexander Hamilton would have had someone to blame: The then-young American republic was forced to pay fierce interest rate premiums in order to borrow money.

2. a. Consumers. But unlike consumer creditors, the lenders to sovereign states have rarely been able to extract returns commensurate with the risk.

3. b. 1989. But Microsoft has only recently begun to behave like G.M. in its heyday. Which raises another question: will Windows go the way of the Fleetwood?

4. MCI. Since the mid-1980's, AT&T has downsized its work force by one-fourth (some 90,000 bodies). Meanwhile, MCI has increased its payroll tenfold. This contrast is no fluke: smaller (and therefore riskier) companies are responsible for creating more than 100 percent of the net increase in jobs in America in the last two decades.

5. d. The recent stock crashes – pardon, market corrections – caused a lot of grief for investors, with 25 percent and 20 percent declines respectively. But the blood really flowed in long-term Treasuries in 1982, with prices falling a stunning 45 percent. Hard times for high-yield bonds in Feb. 1990 cost their owners a mere 4 percent.

6. c. Ratings were born in 1909, to be exact. Did you think J.P. Morgan left home without them?

7. False. Hostile takeovers did become more frequent (and maybe nastier) in the 1980's, when most stocks were selling below the replacement value of the underlying assets. But the first major hostile takeover attempt was probably the Erie Railroad's play for the Albany & Susquehanna Railroad in 1869.

8. a. Bet you're surprised it's just 5 percent. Venture capital is far more important a financing tool in later stages of corporate development.

9. c. Massachusetts and California. For better or worse, a very high proportion of venture capital is going into information technologies.

10. c. 30 percent. That may sound high, but female-owned businesses almost certainly represents a much smaller fraction of business assets. The good news: the number of businesses owned by women is growing twice as rapidly as the number of male-owned enterprises.

11. a. Just 20 percent, implying that 80 percent of the list now consists of self-made fortunes. Perhaps that's because America has become more meritocratic. Or perhaps it's because the stock market capitalizes initial public offerings at ridiculously high multiples of expected earnings.

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INSTITUTE NEWS

GLOBAL CONFERENCE

The 1999 Milken Institute Global Conference, featuring leaders from business, finance, academia and government, is scheduled for March 10 through March 12 at the Beverly Hilton Hotel in Beverly Hills, Calif.

Gray Davis, the newly elected governor of California will speak. In addition, five Nobel Memorial Prize winners in economics – Gary Becker and Merton Miller of the University of Chicago, James Buchanan of George Mason University, Douglass North of Washington University in St. Louis and Myron Scholes of Stanford University – will participate in a discussion led by Institute chairman, Michael Milken.

The three-day conference, which begins with dinner on Wednesday and ends with the Nobel laureates' panel and lunch on Friday, will include a series of discussions on key economic regions of the world: Japan and the Far East, Europe and the new Monetary Union, Russia, China, Mexico and Latin America, and the United States.

An audience of 1,000 is expected, including institutional portfolio managers and leaders of businesses with direct investments worldwide; representatives of major securities firms, money managers and commercial banks; leading academics; senior policy officials from government and multinational lending agencies, as well as financial and business journalists.

For more information, please visit our Web site at www.milken-inst.org, or call the Milken Institute at (310) 998-2605.

NEW POLICY BRIEFS

The Milken Institute has begun a series of short publications highlighting research by our staff. The first, by Ross DeVol, the director of regional studies, was issued in September. *The Asian Crisis Tsunami: Trade and Other Impacts on California and the United States* looked at the consequences of the Asian financial crisis, with a focus on California.

The Institute's new Capital Access Index, ranking economies on the openness of their financial systems, is also part of the series. The first index, published in the fall, examined *Emerging and Submerging Markets.* The second, issued this winter, looked at *Converging and Diverging European Markets.* The index is compiled by Glenn Yago, director of capital studies, and his staff. *Forbes Global* magazine is publishing a condensed version of the quarterly report.

A fourth policy brief, *Hedge Funds and Systemic Risk Demystified,* analyzes the hedge fund market, with a focus on whether the funds' influence on financial markets has been overstated. The brief was written by Yago along with research associates Lalita Ramesh and Noah E. Hochman, and it was made available in December. In January, the Institute published an analysis of the South Korean crisis by the senior fellow Hilton Root and the research analyst Greg Beier. The study addresses the obstacles to reform and proposes ways to get the job done.

View these policy briefs at our web site, or call (310) 998-2600 for reprints.

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POLICY BREAKFAST

On Dec. 3, Michael Milken hosted a breakfast at the Institute for more than two dozen California government and business leaders to discuss pending state and city issues. The informal gathering focussed on job training and education, as well as the lack of a major financial institution in Southern California.

Among government officials attending were Gov. Gray Davis, State Senate President John Burton, Los Angeles Mayor Richard Riordan and L.A. County Supervisor Zev Yaroslavsky.

Business, education and financial leaders included Frank E. Baxter, CEO, Jefferies & Co.; Mike R. Bowlin, CEO, ARCO; Ron Burkle, CEO, the Yucaipa Companies; Albert Carnesale Chancellor of U.C.L.A; Bram Goldsmith, chair, the City National Corp.and Russell Goldsmith, CEO, City National Bank; Carlton Jenkins, CEO, Founders National Bank; Tom Kalinske, president, Knowledge Universe; Bruce Karatz, CEO, Kaufman & Broad; Howard Marks, chair, Oaktree Capital Management; Rupert Murdoch, CEO, and Peter Chernin, COO, the News Corporation, and Lachlan Murdoch, chair, News Ltd.; Jane Pisano, senior VP, U.S.C.; Stewart Resnick, CEO, Roll International; Bill Siart, CEO, EXED L.L.C.; Lorraine Spurge, president, Spurge Inc.; Dennis Tito, president, Wilshire Associates; and Stanley Zax, president, Zenith Insurance.

Deputy Mayor Jennifer Roth of Los Angeles attended, along with Lowell Milken, president, and Richard Sandler, senior vice president, of the Milken Family Foundation. Institute attendees included Donald Straszheim, executive vice president, Ted Van Dyk, and Glenn Yago, director of capital studies. M

Web Site Changes

For the latest information about the Milken Institute and its research, publications and events, visit our revamped Web site (www.milken-inst.org). We have made a number of improvements to make it easier to find what you are looking for, to read publications on line and to give you up-to-date news about what activities.

Among the Web site's new features:

- **"WHAT'S NEW" PAGE. Check here for the latest from the Institute – publications, additions to the staff, recent press releases, upcoming events and the like.**
- **PUBLICATIONS. In addition to books, monographs, briefing books and working papers, we've added our new policy brief series and transcripts of past events, notably the Proceedings of the 1998 Global Conference.**
- **EVENTS. We now list all of the Institute's conferences, seminars and research roundtables under one section called Events.**
- **ABOUT US. We've added e-mail addresses for all of our senior staff, expanded their biographies and added the names and e-mails of our top administrative staff. We've also created an order form that allows you to request as many of our publications as you wish.**

Please let us know what you think of the site by e-mailing us at info@milken-inst.org.

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DADDY, HOW COME, AFTER MORE THAN A DECADE OF 200-AND-300-BILLION-DOLLAR FEDERAL DEFICITS...
...EVERYBODY IS SO EXCITED ABOUT A SMALL, SOCIAL-SECURITY-SUBSIDIZED SURPLUS...
...THAT THEY ACT AS IF OUR 5.5-TRILLION-DOLLAR CUMULATIVE DEBT THAT WE WERE WARNED ABOUT FOR ALL THOSE YEARS IS OF NO CONSEQUENCE?
HE'S SO CUTE!
JUST PRECIOUS!
KIDS SAY THE DARNEDEST THINGS!
WELL, YOU SEE, SON, THERE ARE CERTAIN GROWN-UP THINGS THAT ARE SIMPLY BEYOND A CHILD'S UNDERSTANDING.
YOU MEAN YOU UNDERSTAND IT?
I ACCEPT IT! ACCEPTANCE COMES WITH MATURITY.
BUT HOW COME PEOPLE STOPPED TALKING ABOUT OUR HAVING TO "PAY DOWN THE DEBT"?
BECAUSE WE MUST NOT HAVE TO ANYMORE.
DOES THAT MEAN THAT, WHEN I GROW UP, I CAN GO 20 OR 30 THOUSAND DOLLARS INTO DEBT EVERY YEAR FOR, SAY, 15 YEARS, AND THEN, IF I HAVE ONE YEAR WHEN I EARN A FEW DOLLARS MORE THAN I SPEND, I CAN JUST FORGET ABOUT ALL MY PAST DEBT?
YOU'RE MIXING APPLES AND ORANGES.
MICRO DOLLARS AND MACRO DOLLARS ARE NOT THE SAME THING!
BUT...
LISTEN TO ME. YOU'RE NOT BEING CUTE ANYMORE. ACCEPT THE MEDIA CONSENSUS! DO YOU HEAR ME?!
BUT...
GO TO YOUR ROOM!
BUT...
HE DOESN'T KNOW WHEN TO STOP.
WHAT DO YOU DO WITH A KID LIKE THAT?
RITALIN.

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MILKEN INSTITUTE
Global Conference

MARCH 10-12, 1999

THE BEVERLY HILTON, LOS ANGELES, CA

The Milken Institute's second annual Global Conference brings together some of the world's leading financial, business, government and academic experts to examine today's global economy.

FEATURING DISCUSSIONS ON

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- China
- Russia and the CIS
- Japan and East Asia
- Euroland and the Euro
- The U.S. Economy
- Financial, Business and Public Policy Reforms

SPEAKERS AND PANELISTS INCLUDE

Gray Davis
GOVERNOR, STATE OF CALIFORNIA

Gary Becker, **Merton Miller**, **Douglass North** and **Myron Scholes**
NOBEL LAUREATES IN ECONOMICS

Michael Milken
CHAIRMAN, MILKEN INSTITUTE

...and numerous senior business, finance, government, academic, media and other leaders

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In this issue

PAUL KRUGMAN
on the eerie parallels between 1931 and 1997. Maybe it could happen again.

MICHAEL MILKEN
on the decreasing relevance of corporate balance sheets. Conventional accounting doesn't show the really good stuff.

LARRY LINDSEY
on the risks of European monetary union. Do good neighbors need good fences?

DAN BACHMAN
on the macroeconomics of the Year 2000 computer bug. Even if the software engineers fix the problem, a recession may follow.

BARRY EICHENGREEN
on the case for capital controls in emerging economies. Is it time to throw sand in the wheels of globalism?

NICK EBERSTADT
on the unintended consequences of China's one-child policy. Small may not be beautiful.

HILTON ROOT
on interest-group gridlock in Asia. To understand why crony capitalism resists change, follow the money.

JIM BARTH, DAN BRUMBAUGH & GLENN YAGO
on currency contagion. There's a simpler explanation – one that that doesn't begin with George Soros.

Book reviews by
SYLVIA NASAR & REBECCA FORD

A cartoon strip by
MARK ALAN STAMATY,
creator of *The Washingtoon.*

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